STUDY UNIT NINE
ETHICS

(8 pages of outline)

The outline in this study unit is important to internal auditors both personally and professionally because it addresses their ethical obligations. Ethical responsibilities belong to all professionals: objectivity, integrity, confidential and disinterested use and protection of information, and competence. They are stated in The IIA Code of Ethics, a document that is heavily tested. It is reproduced in full in the second subunit of this study unit. The first subunit provides a useful perspective on ethics.

9.1 PERSPECTIVE ON ETHICS

1. **Definitions**
   a. **Business ethics** concerns an organization's policies and standards established to assure certain kinds of behavior by its members.
   b. **Individual ethics** concerns the moral principles and standards of conduct adhered to by an individual.
2. **Areas of Concern Regarding Business Ethics**
   a. General business understanding of ethical issues
   b. Compliance with laws (tax, securities, antitrust, environmental, labor, etc.)
   c. External financial reporting
   d. Conflicts of interest
   e. Entertainment and gift expenses
   f. Relations with customers and suppliers (Should gifts or kickbacks be given or accepted?)
   g. Social responsibilities
3. **Factors That May Lead to Unethical Behavior**
   a. In any normal population, some people have less than desirable levels of ethics. If these people hold leadership positions, they may adversely influence subordinates.
   b. **Organizational factors**
      1) Pressures to improve short-run performance may promote unethical behavior.
      2) Emphasis on strict adherence to chain-of-command authority may provide excuses for ignoring ethics when following orders.
      3) Informal work-group loyalties may subvert ethical behavior.
      4) Committee decision processes may make it possible to abstain from or avoid ethical obligations.
   c. **External factors**
      1) Pressure of competition may compromise ethics in the interest of survival.
      2) Wrongful behavior of others may force a compromise of ethics.
      3) Definitions of ethical behavior may vary from one culture to another. For instance, bribes to officials or buyers may be consistent with some countries' customary business practices.

4. **General Guides to Ethics**
   a. The **Golden Rule** states, “Do unto others as you would have them do unto you.”
   b. Fairness. Individuals and businesses should act in ways that are fair or just to all concerned.
   c. General respect. Individuals and businesses should act to respect the planet and the rights of others because business decisions have widespread effects.
   d. **Law**. Another view is that adherence to legal codes satisfies ethical obligations.
   e. However, most people believe that law embodies **ethical precepts** but is not coextensive with them. Thus, what is unethical may not be illegal, and nonlegal sources of ethical guidance must be considered.
      1) For example, the philosopher Immanuel Kant devised the **categorical imperative**, an approach to any ethical decision that asks what the consequences would be if all persons in the same circumstances (category) behaved similarly.
      2) **Natural law** concepts are a source of ethical standards because they postulate that certain human rights are fundamental, such as the life, liberty, and the pursuit of happiness, rights mentioned in the U.S. Declaration of Independence. Under this view, a business decision should be evaluated based on how it affects the rights of groups, e.g., consumers or employees.
      3) According to **utilitarian ethics**, a decision is good if it maximizes social utility, that is, provides the greatest good for the greatest number of people.
      4) Various concepts of the **social responsibility** of business have evolved from a greater awareness of ethical obligations.
         a) A limited view is espoused by the economist **Milton Friedman**. He argues that a business must stay “within the rules of the game,” i.e., engage in “open and free competition without deception or fraud,” but is otherwise obligated only to earn profits.
         b) A second view is that businesses must consider the interests of all **stakeholders**, some of whom in a given situation may have interests paramount to the interest of shareholders.
         c) A third view is that major corporations have **citizenship** responsibilities, for example, to protect the environment or promote human rights.

5. **Simplified Criteria for Evaluating Ethical Behavior**
   a. “Would this behavior be acceptable if people I respect knew I was doing this?”
   b. “What are the consequences of this behavior for myself, other employees, customers, society?”

6. Ethics are individual and personal, influenced by
   a. Life experiences (rewards for doing right, punishment for wrong)
   b. Friendship groups (professional associations, informal groups)
   c. Organizational pressures (responsibilities to superiors and the organization)

7. **Codes of Ethical Conduct**
   a. An organization’s code of ethical conduct is the established general value system the organization wishes to apply to its members’ activities by
      1) Communicating organizational purposes and beliefs
      2) Establishing uniform ethical guidelines for members
         a) Including guidance on behavior for members in making decisions

b. Because laws and specific rules cannot cover all situations, organizations benefit from having an established ethical code. The code
   1) Effectively communicates acceptable values to all members
      a) Including recruits and subcontractors
   2) Provides a method of policing and disciplining members for violations
      a) Through formal review panels
      b) Through group pressure (informal)
   3) Establishes high standards against which individuals can measure their own performance
   4) Communicates to those outside the organization the value system from which its members must not be asked to deviate
c. A typical code for auditors or accountants in an organization requires
   1) Independence from conflicts of economic interest
   2) Independence from conflicts of professional interest
      a) They are responsible for presenting information fairly to shareholders or owners rather than protecting management.
      b) They are responsible for presenting appropriate information to all managers. They should not favor certain managers or conceal unfavorable information.
      c) They are responsible for maintaining an ethical presence in the conduct of professional activities.
         i) They should do what they can to ensure organizational compliance with the spirit as well as the letter of pertinent laws and regulations.
         ii) They should conduct themselves according to the highest moral and legal standards.
         iii) They should report to appropriate internal or external authority any illegal or fraudulent organizational act.
   3) Integrity and a refusal to compromise professional values for the sake of personal goals
   4) Objectivity in presenting information, preparing reports, and making analyses
d. In the U.S., the **Sarbanes-Oxley Act of 2002** requires each public company to disclose whether it has adopted a code of ethics for its senior financial officers and the content of the code.
   1) Immediate disclosure is required of any change in, or waiver of, the code.
   2) The act applies to U.S. and foreign companies required to file with the SEC. It also applies to U.S. and foreign public accounting firms that are required to register with the **Public Company Accounting Oversight Board**.

8. Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 1 through 7 beginning on page 8.

9.2 THE IIA CODE OF ETHICS

1. CIA examination candidates should know the 4 Principles and 12 Rules of Conduct. The 12 Rules are summarized below. The full text, including the Introduction and Applicability and Enforcement sections, appears at the end of this subunit.
   a. Perform work with honesty, diligence, and responsibility.
   b. Observe the law and make proper disclosures.
   c. Do not be a party to illegal or improper activity or engage in discreditable acts.
   d. Respect and contribute to organizational objectives.
   e. Avoid activities/relationships, including conflicts of interest, that presumably impair unbiased assessment.
   f. Accept nothing that impairs professional judgment.
   g. Disclose material facts so that reports are not distorted.
   h. Use and protect information prudently.
   i. Do not use information for personal gain or in a way contrary to law or proper organizational objectives.
   j. Perform only services for which they have the needed competencies.
   k. Perform services in accordance with the SPPIA.
   l. Improve proficiency continually.
2. The IIA Code of Ethics should be read in conjunction with the International Standards for the Professional Practice of Internal Auditing.
3. The IIA Code of Ethics applies to individuals and entities, including members of The Institute, CIAs, and candidates for certification. However, it also furnishes guidance to anyone who provides internal auditing services.

THE INSTITUTE OF INTERNAL AUDITORS
CODE OF ETHICS

INTRODUCTION: *The purpose of The Institute's Code of Ethics is to promote an ethical culture in the profession of internal auditing.*

> *Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. The Institute's Code of Ethics extends beyond the definition of internal auditing to include two essential components:

1. *Principles that are relevant to the profession and practice of internal auditing.*
2. *Rules of Conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.*

The Code of Ethics together with The Institute's Professional Practices Framework and other relevant Institute pronouncements provide guidance to internal auditors serving others. "Internal auditors" refers to Institute members, recipients of or candidates for IIA professional certifications, and those who provide internal auditing services within the definition of internal auditing.

APPLICABILITY AND ENFORCEMENT: *This Code of Ethics applies to both individuals and entities that provide internal auditing services.*

For Institute members and recipients of or candidates for IIA professional certifications, breaches of the Code of Ethics will be evaluated and administered according to The Institute's Bylaws and Administrative Guidelines. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member, certification holder, or candidate can be liable for disciplinary action.

Principles

Internal auditors are expected to apply and uphold the following principles:

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

RULES OF CONDUCT

1. ***Integrity***
Internal auditors:

1.1 Shall perform their work with honesty, diligence, and responsibility.

1.2 Shall observe the law and make disclosures expected by the law and the profession.

1.3 Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.

1.4 Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. ***Objectivity***
Internal auditors:

2.1 Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.

2.2 Shall not accept anything that may impair or be presumed to impair their professional judgment.

2.3 Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. ***Confidentiality***
Internal auditors:

3.1 Shall be prudent in the use and protection of information acquired in the course of their duties.

3.2 Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

4. ***Competency***
Internal auditors:

4.1 Shall engage only in those services for which they have the necessary knowledge, skills, and experience.

4.2 Shall perform internal auditing services in accordance with the Standards for the Professional Practice of Internal Auditing.

4.3 Shall continually improve their proficiency and the effectiveness and quality of their services.

4. The following Practice Advisory is pertinent to Standards 2440 and 2600 and to the Rules of Conduct that address **integrity** and **confidentiality**:

Practice Advisory 2440-3: Communicating Sensitive Information Within and Outside of the Chain of Command

1. *Internal auditors often come into the possession of information that is critically sensitive and substantial to the organization and has significant potential consequences. That information may relate to exposures, threats, uncertainties, fraud, waste and mismanagement, illegal activities, abuse of power, misconduct that endangers public health or safety, or other wrongdoings. Those types of matters may adversely impact the organization's reputation, image, competitiveness, success, viability, market values, investments and intangible assets, or earnings. They are likely to increase an organization's risk exposures.*

Communicating Sensitive Information to Those in the Chain of Command

2. *Once the internal auditor has decided that the new information is substantial and credible, the auditor would normally communicate the information, on a timely basis, to those in management who can act on it. In most instances, those communications will resolve the matter from an internal audit perspective, so long as management takes the appropriate action to manage the associated risks. If the communications result in a conclusion that management, by its inadequate or lack of actions, is exposing the organization to an unacceptable level of risk, the chief audit executive (CAE) should consider other options to achieve a satisfactory resolution.*

3. *Among those possible actions, the CAE could discuss his or her concerns about the risk exposure with senior management within his or her normal chain of command. Since the audit or other committee of the governing board would also be expected to be in the CAE's chain of command, the members of the board committee would normally be apprised of the CAE's concerns. If the CAE, after those discussions with senior management, is still unsatisfied and concludes that senior management is exposing the organization to an unacceptable risk and is not taking appropriate action to halt or correct the situation, senior management and the CAE would present the essential information and their differences of opinion to the members or a committee of the governing board.*

4. *That simple chain-of-command communication scenario may be accelerated for certain types of sensitive occurrences because of national laws, regulations, or commonly followed practices. For instance, in the case of evidence of fraudulent financial reporting by a company with publicly traded securities in the United States, regulations prescribe that the audit committee of the board be immediately informed of the circumstances surrounding the possibility of misleading financial reports, even though senior management and the CAE may be in substantial agreement on what actions need to be taken. Laws and regulations in several countries specify that members or a committee of the governing board should be informed of discoveries of violations of criminal, securities, food, drugs, or pollution laws and other illegal acts, such as bribery or other improper payments to government officials or to agents of suppliers or customers.*

Communicating Outside of the Chain of Command

5. *In some situations, an internal auditor may face the dilemma of considering whether to communicate the discovered information to persons outside of the normal chain of command or even outside of the organization. The act of disclosing adverse information to someone in the organization who is outside of the individual's normal chain of command, or to a governmental agency or other authority that is wholly outside of the organization, is commonly referred to as "whistleblowing."*

6. *In studies about whistleblowing, it has been reported that most whistleblowers disclose the sensitive information internally, even if outside of the normal chain of command, particularly if they trust the policies and mechanisms of the organization to investigate an allegation of an illegal or other improper activity and to take appropriate action.*

However, some persons possessing sensitive information may decide to take the information outside the organization, particularly if they fear retribution by their employers or fellow employees, have doubt that the issue will be properly investigated, believe that it will be concealed, or possess evidence about an illegal or improper activity that jeopardizes the health, safety, or well-being of people in the organization or community. The primary motive of most whistleblowers, who are acting on good faith, is to halt the illegal, harmful, or improper behavior.

7. *An internal auditor who is facing a similar dilemma and needing to consider all possible options will need to evaluate alternative ways to communicate the risk to some person or group who is outside of his or her normal chain of command. Because of risks and ramifications associated with these approaches, the internal auditor should proceed with care to evaluate the evidence and the reasonableness of his or her conclusions and to examine the merits and disadvantages of each potential action. Taking this type of action by an internal auditor may be appropriate if it will result in responsible action by persons in senior management or in governance positions, such as members on the governing board or one of its committees. An internal auditor would likely consider as his or her last option that of communicating outside of the organization's governance structure. An internal auditor would reserve this type of action for those rare occasions when he or she is convinced that the risk and its possible consequences are serious and there is high probability that the organization's existing management and governance mechanisms can not or will not effectively address the risk.*

8. *Many member countries in the OECD (Organization for Economic Cooperation and Development) have laws or administrative regulations requiring public servants with knowledge of illegal or unethical acts to inform an Inspector General, other public official, or ombudsman. Some national laws pertaining to whistleblowing-type actions protect citizens if they come forward to disclose specific types of improper activities. Among the activities listed in the laws and regulations of those countries are:*

   - *Criminal offenses and other failures to comply with legal obligations.*
   - *Acts that are considered miscarriages of justice.*
   - *Acts that endanger the health, safety, or well-being of individuals.*
   - *Acts that damage the environment.*
   - *Activities that conceal or cover up any of the above.*

   Other countries offer no guidance or protection. The internal auditor should be aware of the laws and regulations of the various localities in which the organization operates and should take actions that are consistent with those legal requirements. The internal auditor should consider obtaining legal advice if he or she is uncertain of the applicable legal requirements.

9. *Many professional associations hold their members to a duty to disclose illegal or unethical activities. The distinguishing mark of a "profession" is its acceptance of broad responsibilities to the public and its protection of the general welfare. In addition to examining the legal requirements, IIA members and all Certified Internal Auditors should follow the requirements outlined in The IIA Code of Ethics concerning illegal or unethical acts.*

Internal Auditor's Decision

10. *An internal auditor has a professional duty and an ethical responsibility to evaluate carefully all the evidence and the reasonableness of his or her conclusions and, then, to decide whether further actions may be needed to protect the interests of the organization, its stakeholders, the outside community, or the institutions of society. Also, the auditor will need to consider the duty of confidentiality, imposed by The IIA Code of Ethics, to respect the value and ownership of information and avoid disclosing it without appropriate authority, unless there is a legal or professional obligation to do so. In this evaluation process, the auditor should seek the advice of legal counsel and, if appropriate, other experts. Those discussions may be helpful in providing a different perspective on the circumstances as well as offering opinions about the potential impact and consequences of various possible actions. The manner in which the internal auditor seeks to resolve this type of complex and sensitive situation may create reprisals and potential liability.*

11. *Ultimately, the internal auditor must make a personal decision. The decision to communicate outside the normal chain of command should be based on a well-informed opinion that the wrongdoing is supported by substantial, credible evidence and that a legal or regulatory imperative or a professional or ethical obligation requires further action. The auditor's motive for acting should be the desire to stop the wrongful, harmful, or improper activity.*

5. Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 8 through 46 beginning on page 10.

QUESTIONS

9.1 Perspective on Ethics

1. A code of conduct was developed several years ago and distributed by a large financial institution to all its officers and employees. Identify the internal auditor's best approach to provide the board with the highest level of comfort about the code of conduct.

A. Fully evaluate the comprehensiveness of the code and compliance therewith, and report the results to the board.

B. Fully evaluate organizational practices for compliance with the code, and report to the board.

C. Review employee activities for compliance with provisions of the code, and report to the board.

D. Perform tests on various employee transactions to detect potential violations of the code of conduct.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The approach that provides the highest level of comfort about the code of conduct.

DISCUSSION: When evaluating a code of conduct, it is important to consider two items: comprehensiveness and compliance. The code should address the ethical issues that the employees are expected to encounter and provide suitable guidance. The internal auditor must also consider the extent to which employees are complying with the standards established.

Answer (B) is incorrect because evaluating practices and reporting to the board is not the best approach. Answer (C) is incorrect because reviewing employee activities does not provide as much comfort about the code of conduct as evaluation of comprehensiveness. Answer (D) is incorrect because performing tests on employee transactions is not the best approach.

2. A primary purpose for establishing a code of conduct within a professional organization is to

A. Reduce the likelihood that members of the profession will be sued for substandard work.

B. Ensure that all members of the profession perform at approximately the same level of competence.

C. Promote an ethical culture among professionals who serve others.

D. Require members of the profession to exhibit loyalty in all matters pertaining to the affairs of their organization.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The primary purpose for establishing a code of conduct within a professional organization.

DISCUSSION: The IIA Code of Ethics is typical. Its purpose is "to promote an ethical culture in the profession of internal auditing." The definition of internal auditing states that it is "an independent, objective assurance and consulting activity." Moreover, internal auditing is founded on "the trust placed in its objective assurance about risk management, control, and governance." The IIA Code of Ethics further emphasizes that it provides guidance to internal auditors "serving others."

Answer (A) is incorrect because, although this result may follow from establishing a code of conduct, it is not the primary purpose. To consider it so would be self-serving. Answer (B) is incorrect because a code of conduct may help to establish minimum standards of competence, but it would be impossible to legislate equality of competence by all members of a profession. Answer (D) is incorrect because, in some situations, responsibility to the public at large may conflict with, and be more important than, loyalty to one's organization.

3. An accounting association established a code of ethics for all members. What is one of the association's primary purposes for establishing the code of ethics?

A. To outline criteria for professional behavior to maintain standards of integrity and objectivity.

B. To establish standards to follow for effective accounting practice.

C. To provide a framework within which accounting policies could be effectively developed and executed.

D. To outline criteria that can be used in conducting interviews of potential new accountants.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The primary purpose for establishing a code of ethics.

DISCUSSION: The IIA Code of Ethics includes Principles and Rules of Conduct. Internal auditors are expected to apply and uphold four principles: integrity, objectivity, confidentiality, and competence.

Answer (B) is incorrect because national standard-setting bodies, not a code of ethics, provide guidance for effective accounting practice. Answer (C) is incorrect because a code of ethics does not provide the framework within which accounting policies are developed. Answer (D) is incorrect because the primary purpose is not for interviewing new accountants.

4. A review of an organization's code of conduct revealed that it contained comprehensive guidelines designed to inspire high levels of ethical behavior. The review also revealed that employees were knowledgeable of its provisions. However, some employees still did not comply with the code. What element should a code of conduct contain to enhance its effectiveness?

A. Periodic review and acknowledgment by all employees.

B. Employee involvement in its development.

C. Public knowledge of its contents and purpose.

D. Provisions for disciplinary action in the event of violations.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The element that would enhance the effectiveness of a code of conduct.

DISCUSSION: Penalties for violations of a code of conduct should enhance its effectiveness. Some individuals will be deterred from misconduct if they expect it to be detected and punished.

Answer (A) is incorrect because periodic review and acknowledgment would ensure employee knowledge and acceptance of the code, which are not at issue. Answer (B) is incorrect because employee involvement in development would encourage employee acceptance, which is not at issue. Answer (C) is incorrect because public knowledge might affect the behavior of some individuals but not to the same extent as the perceived likelihood of sanctions for wrongdoing.

5. In analyzing the differences between two recently merged businesses, the chief audit executive of Organization A notes that it has a formal code of ethics and Organization B does not. The code of ethics covers such things as purchase agreements, relationships with vendors, and other issues. Its purpose is to guide individual behavior within the firm. Which of the following statements regarding the existence of the code of ethics in A can be logically inferred?

I. A exhibits a higher standard of ethical behavior than does B.

II. A has established objective criteria by which an individual's actions can be evaluated.

III. The absence of a formal code of ethics in B would prevent a successful review of ethical behavior in that organization.

A. I and II.

B. II only.

C. III only.

D. II and III.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The inference(s) regarding the existence or absence of a formal code of ethics.

DISCUSSION: A formal code of ethics effectively communicates acceptable values to all members, provides a method of policing and disciplining members for violations, establishes objective standards against which individuals can measure their own performance, and communicates the organization's value system to outsiders.

6. The best reason for establishing a code of conduct within an organization is that such codes

A. Are typically required by governments.

B. Express standards of individual behavior for members of the organization.

C. Provide a quantifiable basis for personnel evaluations.

D. Have tremendous public relations potential.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The best reason for an organizational code of conduct.

DISCUSSION: An organization's code of ethical conduct is the established general value system the organization wishes to apply to its members' activities by communicating organizational purposes and beliefs and establishing uniform ethical guidelines for members, which include guidance on behavior for members in making decisions. Because laws and specific rules cannot cover all situations, organizations can benefit from having an established ethical code. It effectively communicates acceptable values to all members, including recruits and subcontractors. It also provides a method of policing and disciplining members for violations through formal review panels and group pressure (informal). A code establishes high standards against which individuals can measure their own performance and communicates to those outside the organization the value system from which its members must not be asked to deviate.

Answer (A) is incorrect because governments typically have no such requirement. Answer (C) is incorrect because codes of conduct provide qualitative, not quantitative, standards. Answer (D) is incorrect because other purposes of a code of conduct are much more significant.

7. Which of the following statements is not appropriate to include in a manufacturer's conflict of interest policy? An employee shall not

A. Accept money, gifts, or services from a customer.

B. Participate (directly or indirectly) in the management of a public agency.

C. Borrow from or lend money to vendors.

D. Use organizational information for private purposes.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The item not included in a manufacturer's conflict of interest policy.

DISCUSSION: A prohibition on public service is ordinarily inappropriate. It is a right, if not a duty, of all citizens.

Answer (A) is incorrect because a conflict of interest policy should prohibit the transfer of benefits between an employee and those with whom the organization deals. Answer (C) is incorrect because a conflict of interest policy should prohibit financial dealings between an employee and those with whom the organization deals. Answer (D) is incorrect because The IIA Code of Ethics prohibits use of information for personal gain (Rule of Conduct 3.2).

9.2 The IIA Code of Ethics

8. In applying the Rules of Conduct set forth in The IIA Code of Ethics, internal auditors are expected to

A. Not be unduly influenced by their own interests in forming judgments.

B. Compare them with standards of other professions.

C. Be guided by the desires of the engagement client.

D. Use discretion in deciding whether to use them.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The responsibility of internal auditors under The IIA Code of Ethics.

DISCUSSION: According to the objectivity principle stated in The IIA Code of Ethics, internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Answer (B) is incorrect because standards of other professions are not intended to provide guidance to internal auditors serving others. Answer (C) is incorrect because auditors should be independent of the engagement client. Answer (D) is incorrect because internal auditors must follow The IIA Code of Ethics.

9. The Rules of Conduct set forth in The IIA Code of Ethics

A. Describe behavior norms expected of internal auditors.

B. Are guidelines to assist internal auditors in dealing with engagement clients.

C. Are interpreted by the Principles.

D. Apply only to particular conduct specifically mentioned.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The true statement about The IIA Code of Ethics.

DISCUSSION: A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. The Institute's Code of Ethics extends beyond the definition of internal auditing to include two essential components: (1) Principles that are relevant to the profession and practice of internal auditing and (2) Rules of Conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

Answer (B) is incorrect because the Rules of Conduct provide guidance to internal auditors in the discharge of their responsibility to all those whom they serve. Engagement clients are not the only parties served by internal auditing. Answer (C) is incorrect because the Rules of Conduct are an aid in interpreting the Principles. Answer (D) is incorrect because the conduct may be unacceptable or discreditable although not mentioned in the Rules of Conduct.

10. The Code of Ethics requires internal auditors to perform their work with

A. Honesty, diligence, and responsibility.

B. Timeliness, sobriety, and clarity.

C. Knowledge, skills, and competencies.

D. Punctuality, objectivity, and responsibility.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The qualities internal auditors should exhibit in the performance of their work.

DISCUSSION: Four rules are stated under the integrity principle. According to Rule of Conduct 1.1 of The IIA Code of Ethics, "Internal auditors shall perform their work with honesty, diligence, and responsibility."

Answer (B) is incorrect because timeliness, sobriety, and clarity are not mentioned in the Code. Answer (C) is incorrect because knowledge, skills, and competencies are mentioned in the *Standards for the Professional Practice of Internal Auditing*. Answer (D) is incorrect because punctuality is not mentioned in the Code.

11. Which of the following is permissible under The IIA Code of Ethics?

A. Disclosing confidential, engagement-related, information that is potentially damaging to the organization in response to a court order.

B. Using engagement-related information in a decision to buy an ownership interest in the employer organization.

C. Accepting an unexpected gift from an employee whom the internal auditor has praised in a recent engagement communication.

D. Not reporting significant observations and recommendations about illegal activity to the board because management has indicated it will address the issue.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The action permissible under The IIA Code of Ethics.

DISCUSSION: Under Rule of Conduct 1.2, "Internal auditors shall observe the law and make disclosures expected by the law and the profession." Thus, the requirement not to use information in any manner detrimental to the legitimate and ethical objectives of the organization (Rule of Conduct 3.2) does not override the legal obligation to respond to a court order.

Answer (B) is incorrect because Rule of Conduct 3.2 prohibits internal auditors from using information for personal gain. Answer (C) is incorrect because Rule of Conduct 2.2 prohibits internal auditors from accepting anything that may impair or be presumed to impair their professional judgment. Answer (D) is incorrect because Rule of Conduct 1.3 prohibits knowingly being a party to any illegal activity. Internal auditors must also disclose all material facts known to them that, if not disclosed, might distort the reporting of activities under review (Rule of Conduct 2.3).

12. An internal auditor, working for a chemical manufacturer, believed that toxic waste was being dumped in violation of the law. Out of loyalty to the organization, no information regarding the dumping was collected. The internal auditor

A. Violated the Code of Ethics by knowingly becoming a party to an illegal act.

B. Violated the Code of Ethics by failing to protect the well-being of the general public.

C. Did not violate the Code of Ethics. Loyalty to the employer in all matters is required.

D. Did not violate the Code of Ethics. Conclusive information about wrongdoing was not gathered.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The ethical implication of failing to gather information about the organization's illegal act.

DISCUSSION: Rule of Conduct 1.3 prohibits knowingly being a party to any illegal activity. Internal auditors must also disclose all material facts known to them that, if not disclosed, might distort the reporting of activities under review (Rule of Conduct 2.3). The internal auditor apparently also failed to perform his/her work with diligence (Rule of Conduct 1.1).

Answer (B) is incorrect because The IIA Code of Ethics does not impose a duty to the general public. Answer (C) is incorrect because an internal auditor may not use information in any manner detrimental to the legitimate and ethical objectives of the organization (Rule of Conduct 3.2) and must respect and contribute to such objectives (Rule of Conduct 1.4). However, illegal dumping of toxic waste is neither legitimate nor ethical. Answer (D) is incorrect because the internal auditor should have collected and reported such information in accordance with the SPPIA.

13. An internal auditor discovered some material inefficiencies in a purchasing function. The purchasing manager is the internal auditor's next-door neighbor and best friend. In accordance with The IIA Code of Ethics, the internal auditor should

A. Objectively include the facts of the case in the engagement communications.

B. Not report the incident because of loyalty to the friend.

C. Include the facts of the case in a special communication submitted only to the friend.

D. Not report the friend unless the activity is illegal.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The proper internal auditor action given a conflict between professional duty and friendship.

DISCUSSION: Under Rule of Conduct 2.3, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." Furthermore, under Rule of Conduct 1.4, "Internal auditors shall respect and contribute to the legitimate and ethical objectives of the organization."

14. The chief audit executive (CAE) has been appointed to a committee to evaluate the appointment of the external auditors. The engagement partner for the external accounting firm wants the CAE to join him for a week of hunting at his private lodge. The CAE should

A. Accept, assuming both their schedules allow it.

B. Refuse on the grounds of conflict of interest.

C. Accept as long as it is not charged to employer time.

D. Ask the comptroller whether accepting the invitation is a violation of the organization's code of ethics.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The CAE's response to a social invitation by an external auditor who is subject to evaluation by a committee on which the CAE serves.

DISCUSSION: Under Rule of Conduct 2.1, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization." Furthermore, under Rule of Conduct 2.2, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

Answer (A) is incorrect because the auditor should not accept. Answer (C) is incorrect because not changing the time to the company is not sufficient to eliminate conflict-of-interest concerns. Answer (D) is incorrect because the auditor should know that accepting the invitation raises conflict of interest issues.

15. An internal auditor for a large regional bank was asked to serve on the board of directors of a local bank. The bank competes in many of the same markets as the regional bank but focuses more on consumer financing than on business financing. In accepting this position, the internal auditor

I. Violates The IIA Code of Ethics because serving on the board may be in conflict with the best interests of the internal auditor's employer.

II. Violates The IIA Code of Ethics because the information gained while serving on the board of directors of the local bank may influence recommendations regarding potential acquisitions.

A. I only.

B. II only.

C. I and II.

D. Neither I nor II.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The possible violation(s), if any, of The IIA Code of Ethics.

DISCUSSION: Under Rule of Conduct 2.1, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization." Accordingly, service on the board of the local bank constitutes a conflict of interest and may prejudice the internal auditor's ability to carry out objectively his/her duties regarding potential acquisitions.

16. Which of the following concurrent occupations could appear to subvert the ethical behavior of an internal auditor?

A. Internal auditor and a well-known charitable organization's local in-house chairperson.

B. Internal auditor and part-time business insurance broker.

C. Internal auditor and adjunct faculty member of a local business college that educates potential employees.

D. Internal auditor and landlord of multiple housing that publicly advertises for tenants in a local community newspaper listing monthly rental fees.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The concurrent occupations that could create an ethical issue.

DISCUSSION: Under Rule of Conduct 2.1, "Internal auditors shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization." As a business insurance broker, the internal auditor may lose his/her objectivity because (s)he might benefit from a change in the employer's insurance coverage.

Answer (A) is incorrect because the activities of a charity are unlikely to be contrary to the interests of the organization. Answer (C) is incorrect because teaching is compatible with internal auditing. Answer (D) is incorrect because, whereas dealing in commercial properties might involve a conflict, renting residential units most likely does not.

17. Internal auditors should be prudent in their relationships with persons and organizations external to their employers. Which of the following activities will most likely not adversely affect internal auditors' ethical behavior?

A. Accepting compensation from professional organizations for consulting work.

B. Serving as consultants to competitor organizations.

C. Serving as consultants to suppliers.

D. Discussing engagement plans or results with external parties.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The external relationship most likely not to involve an ethics violation.

DISCUSSION: Professional organizations are unlikely to be employees, clients, customers, suppliers, or business associates of the organization. Hence, the consulting fees are not likely to impair or be presumed to impair the internal auditors' professional judgment (Rule of Conduct 2.2). Moreover, relationships with professional organizations are not likely to create a conflict of interest or impair or be presumed to impair internal auditors' unbiased judgment (Rule of Conduct 2.1). Also, the consulting engagement should not result in the improper use of information (Rule of Conduct 3.2).

Answer (B) is incorrect because serving as a consultant to competitors might create a conflict of interest. Answer (C) is incorrect because serving as a consultant to suppliers might create a conflict of interest. Answer (D) is incorrect because internal auditors should "be prudent in the use and protection of information acquired in the course of their duties" (Rule of Conduct 3.1). Furthermore, such discussion might be "detrimental to the legitimate and ethical objectives of the organization" (Rule of Conduct 3.2).

18. An internal auditor has been assigned to an engagement at a foreign subsidiary. The internal auditor is aware that the social climate of the country is such that "facilitating payments" (bribes) are an accepted part of doing business. The internal auditor has completed the engagement and has found significant weaknesses relating to important controls. The subsidiary's manager offers the internal auditor a substantial "facilitating payment" to omit the observations from the final engagement communication with a provision that the internal auditor could revisit the subsidiary in 6 months to verify that the problem areas have been properly addressed. The internal auditor should

A. Not accept the payment because such acceptance is in conflict with the Code of Ethics.

B. Not accept the payment, but omit the observations as long as a verification visit is made in 6 months.

C. Accept the offer because it is consistent with the ethical concepts of the country in which the subsidiary is doing business.

D. Accept the payment because it has the effect of doing the greatest good for the greatest number; the internal auditor is better off, the subsidiary is better off, and the organization is better off because there is strong motivation to correct the deficiencies.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The proper action an internal auditor should take when offered a bribe.

DISCUSSION: Rule of Conduct 2.2 states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

Answer (B) is incorrect because Rule of Conduct 2.3 requires internal auditors to "disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." Answer (C) is incorrect because the profession's standards, not the customs of individual countries or regions, should guide the internal auditor's conduct. Answer (D) is incorrect because the action is explicitly prohibited by the Code of Ethics.

19. An internal auditor engages in the preparation of income tax forms during the tax season. For which of the following activities will the internal auditor most likely be in violation of The IIA Code of Ethics?

A. Writing a tax guide intended for publication and sale to the general public.

B. Preparing the personal tax return, for a fee, for one of the organization's division managers.

C. Teaching an evening tax seminar, for a fee, at a local university.

D. Preparing tax returns for elderly citizens, regardless of their associations, as a public service.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The activity most likely a violation of The IIA Code of Ethics.

DISCUSSION: Rule of Conduct 2.2 states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment." Preparing a personal tax return for a division manager for a fee falls under this prohibition.

20. An internal auditing team has made observations and recommendations that should significantly improve a division's operating efficiency. Out of appreciation of this work, and because it is the holiday season, the division manager presents the in-charge internal auditor with a gift of moderate value. Which of the following best describes the action prescribed by The IIA Code of Ethics?

A. Not accept it prior to submission of the final engagement communication.

B. Not accept it if the gift is presumed to impair the internal auditor's judgment.

C. Not accept it, regardless of other circumstances, because its value is significant.

D. Accept it, regardless of other circumstances, because its value is insignificant.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The action prescribed by The IIA Code of Ethics when an engagement client makes a gift to an internal auditor.

DISCUSSION: Rule of Conduct 2.2 states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

Answer (A) is incorrect because the timing of the gift is irrelevant. Answer (C) is incorrect because the Rule of Conduct uses the word "anything." Answer (D) is incorrect because the gift's acceptance should be based on whether the internal auditor's professional judgment will be impaired or be presumed to be impaired.

21. A CIA is working in a noninternal auditing position as the director of purchasing. The CIA signed a contract to procure a large order from the supplier with the best price, quality, and performance. Shortly after signing the contract, the supplier presented the CIA with a gift of significant monetary value. Which of the following statements regarding the acceptance of the gift is true?

A. Acceptance of the gift is prohibited only if it is not customary.

B. Acceptance of the gift violates The IIA Code of Ethics and is prohibited for a CIA.

C. Because the CIA is no longer acting as an internal auditor, acceptance of the gift is governed only by the organization's code of conduct.

D. Because the contract was signed before the gift was offered, acceptance of the gift does not violate either The IIA Code of Ethics or the organization's code of conduct.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The true statement about acceptance of a gift from a supplier.

DISCUSSION: Members of The Institute of Internal Auditors and recipients of, or candidates for, IIA professional certifications are subject to disciplinary action for breaches of The IIA Code of Ethics. Rule of Conduct 2.2 states, "Internal auditors shall not accept anything that may impair or be presumed to impair their professional judgment."

Answer (A) is incorrect because acceptance of the gift could easily be presumed to have impaired the CIA's professional judgment. Answer (C) is incorrect because the CIA is still governed by The IIA's code of conduct. Answer (D) is incorrect because the timing of signing the contract is irrelevant.

22. In some countries, governmental units have established audit standards. For example, in the United States, the General Accounting Office has developed standards for the conduct of governmental audits, particularly those that relate to compliance with government grants. In performing governmental grant compliance audits, the auditor should

A. Be guided only by the governmental standards.

B. Be guided only by The IIA Standards because they are more encompassing.

C. Be guided by the more general standards that have been issued by the public accounting profession.

D. Follow both The IIA Standards and any additional governmental standards.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The standards an auditor follows when performing governmental grant compliance audits.

DISCUSSION: Rule of Conduct 4.2 of The IIA Code of Ethics states, "Internal auditors shall perform internal auditing services in accordance with the *Standards for the Professional Practice of Internal Auditing*." Furthermore, an internal auditor is legally obligated to adhere to governmental standards when performing governmental grant compliance audits.

23. An organization has recently placed a former operating manager in the position of chief audit executive (CAE). The new CAE is not a member of The IIA and is not a CIA. Henceforth, the internal audit activity will be run strictly by the CAE's standards, not The IIA's. All four staff internal auditors are members of The IIA, but they are not CIAs. According to The IIA Code of Ethics, what is the best course of action for the staff internal auditors?

A. The Code does not apply because they are not CIAs.

B. They should comply with the Standards for the Professional Practice of Internal Auditing.

C. They must respect the legitimate and ethical objectives of the organization and ignore the Standards.

D. They must resign their jobs to avoid improper activities.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The best course of action when the CAE is not a member of The IIA and not a CIA but the staff are members of The IIA.

DISCUSSION: Rule of Conduct 4.2 of The IIA Code of Ethics states, "Internal auditors shall perform internal auditing services in accordance with the *Standards for the Professional Practice of Internal Auditing*." Because the internal auditors are members of The Institute, The IIA Code of Ethics is enforceable against them even though they are not CIAs.

Answer (A) is incorrect because The IIA Code of Ethics may be enforced against IIA members and recipients of, or candidates for, IIA professional certifications. Answer (C) is incorrect because internal auditors should respect and contribute to the legitimate and ethical objectives of the organization, but an IIA member, a holder of an IIA professional certification, or a candidate for certification may be liable for disciplinary action for failure to adhere to the Standards. Answer (D) is incorrect because The IIA Code of Ethics says nothing about resignation to avoid improper activities.

24. A new staff internal auditor was told to perform an engagement in an area with which the internal auditor was not familiar. Because of time constraints, no supervision was provided. The assignment represented a good learning experience, but the area was clearly beyond the internal auditor's competence. Nonetheless, the internal auditor prepared comprehensive working papers and communicated the results to management. In this situation,

A. The internal audit activity violated the Standards by hiring an internal auditor without proficiency in the area.

B. The internal audit activity violated the Standards by not providing adequate supervision.

C. The chief audit executive has not violated The IIA Code of Ethics because it does not address supervision.

D. The Standards and The IIA Code of Ethics were followed by the internal audit activity.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The effect of failing to supervise an internal auditor who lacks proficiency in the area of the engagement.

DISCUSSION: Although The IIA Code of Ethics does not address supervision directly, it does require that the Standards be followed (Rule of Conduct 4.2). The Standards require engagements to be performed with proficiency and due professional care (Standard 1200). They also should be properly supervised to ensure that objectives are achieved, quality is assured, and staff is developed (Standard 2340).

Answer (A) is incorrect because all internal auditors need not be proficient in all areas. The internal audit activity should have an appropriate mix of skills. Answer (C) is incorrect because the Code requires compliance with the Standards, and the Standards require proper supervision. Answer (D) is incorrect because the Standards and the Code were not followed.

25. Which situation most likely violates The IIA Code of Ethics and the Standards?

A. The chief audit executive (CAE) disagrees with the engagement client about the observations and recommendations in a sensitive area. The CAE discusses the detail of the observations and the proposed recommendations with a fellow CAE from another organization.

B. An organization's charter for the internal audit activity requires the chief audit executive (CAE) to present the yearly engagement work schedule to the board for its approval and suggestions.

C. The engagement manager has removed the most significant observations and recommendations from the final engagement communication. The in-charge internal auditor opposed the removal, explaining that (s)he knows the reported conditions exist. The in-charge internal auditor agrees that, technically, information is not sufficient to support the observations, but management cannot explain the conditions and the observations are the only reasonable conclusions.

D. Because the internal audit activity lacks skill and knowledge in a specialty area, the chief audit executive (CAE) has hired an expert. The engagement manager has been asked to review the expert's approach to the assignment. Although knowledgeable about the area under review, the manager is hesitant to accept the assignment because of lack of expertise.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The situation most likely to be considered a violation of The IIA Code of Ethics.

DISCUSSION: According to Rule of Conduct 3.1 of The IIA Code of Ethics, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." According to Rule of Conduct 3.2, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization." Consequently, discussion of sensitive matters with an unauthorized party is the situation most likely to be considered a Code violation. The information conveyed might be used to the detriment of the organization.

Answer (B) is incorrect because approval of the engagement work schedule by the board and senior management is required (Standard 2020). Answer (C) is incorrect because information must be sufficient to achieve engagement objectives (Standard 2300). Answer (D) is incorrect because the Standards allow use of experts when needed.

26. During the course of an engagement, an internal auditor discovers that a clerk is embezzling funds from the organization. Although this is the first embezzlement ever encountered and the organization has a security department, the internal auditor decides to interrogate the suspect. If the internal auditor is violating The IIA Code of Ethics, the rule violated is most likely

A. Failing to exercise due diligence.

B. Lack of loyalty to the organization.

C. Lack of competence in this area.

D. Failing to comply with the law.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The ethics rule most likely violated.

DISCUSSION: Rule of Conduct 4.1 under the competency principle states, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." Internal auditors may not have and are not expected to have knowledge equivalent to that of a person whose primary responsibility is to detect and investigate fraud.

Answer (A) is incorrect because the requirement to perform work with diligence does not override the competency Rules of Conduct or the need to use good judgment. Answer (B) is incorrect because loyalty is better exhibited by consulting professionals and knowing the limits of competence. Answer (D) is incorrect because the internal auditor may violate the suspect's civil rights as a result of inexperience.

27. Which of the following actions taken by a chief audit executive (CAE) could be considered professionally ethical under The IIA Code of Ethics?

A. The CAE decides to delay an engagement at a branch so that his nephew, the branch manager, will have time to "clean things up."

B. To save organizational resources, the CAE cancels all staff training for the next 2 years on the basis that all staff are too new to benefit from training.

C. To save organizational resources, the CAE limits procedures at foreign branches to confirmations from branch managers that no major personnel changes have occurred.

D. The CAE refuses to provide information about organizational operations to his father, who is a part owner.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: Ethical actions under The IIA Code of Ethics.

DISCUSSION: According to Rule of Conduct 3.1 of The IIA Code of Ethics, "Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties." According to Rule of Conduct 3.2, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization." Thus, such use of information by the CAE might be illegal under insider trading rules.

Answer (A) is incorrect because according to Rule of Conduct 1.1, "Internal auditors shall perform their work with honesty, diligence, and responsibility." Answer (B) is incorrect because according to Rule of Conduct 4.3, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services." Answer (C) is incorrect because according to Rule of Conduct 4.2, "Internal auditors shall perform internal auditing services in accordance with the Standards for the Professional Practice of Internal Auditing." The Standards require supporting information to be sufficient, reliable, relevant, and useful.

28. Which of the following situations is a violation of The IIA Code of Ethics?

A. An internal auditor was ordered to testify in a court case in which a merger partner claimed to have been defrauded by the internal auditor's organization. The internal auditor divulged confidential information to the court.

B. An internal auditor for a manufacturer of office products recently completed an engagement to evaluate the marketing function. Based on this experience, the internal auditor spent several hours one Saturday working as a paid consultant to a hospital in the local area that intended to conduct an engagement to evaluate its marketing function.

C. An internal auditor gave a speech at a local IIA chapter meeting outlining the contents of a program the internal auditor had developed for engagements relating to electronic data interchange (EDI) connections. Several internal auditors from major competitors were in the audience.

D. During an engagement, an internal auditor learned that the organization was about to introduce a new product that would revolutionize the industry. Because of the probable success of the new product, the product manager suggested that the internal auditor buy an additional interest in the organization, which the internal auditor did.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The violation of The IIA Code of Ethics.

DISCUSSION: According to Rule of Conduct 3.2, "Internal auditors shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization."

Answer (A) is incorrect because according to Rule of Conduct 1.2, "Internal auditors shall observe the law and make disclosures expected by the law and the profession." Failure to comply with a court order is illegal. Answer (B) is incorrect because the hospital is not a competitor or supplier of the internal auditor's employer. Hence, no conflict of interest is involved. Answer (C) is incorrect because giving a speech is not a violation of The IIA Code of Ethics. In fact, The IIA's motto is "progress through sharing."

29. A chief audit executive (CAE) learned that a staff internal auditor provided confidential information to a relative. Both the CAE and staff internal auditor are CIAs. Although the internal auditor did not benefit from the transaction, the relative used the information to make a significant profit. The most appropriate way for the CAE to deal with this problem is to

A. Verbally reprimand the internal auditor.

B. Summarily discharge the internal auditor and notify The IIA.

C. Take no action because the internal auditor did not benefit from the transaction.

D. Inform the Institute's Board of Directors and take the personnel action required by organizational policy.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The CAE's appropriate action after learning that a staff internal auditor has provided confidential information to a relative.

DISCUSSION: The staff internal auditor has violated Rule of Conduct 3.2 regarding use of information. A violation of The IIA Code of Ethics is the basis for a complaint to the International Ethics Committee, which is responsible for receiving, interpreting, and investigating all complaints against members or CIAs on behalf of the Board of Directors of The IIA, and making recommendations to the Board on actions to be taken (Administrative Directive 5). In addition, organizational policy must be followed.

Answer (A) is incorrect because the internal auditor has violated Rule of Conduct 3.2 regarding use of information. The IIA should be notified. Answer (B) is incorrect because summary discharge may not be in accordance with company personnel policies. Answer (C) is incorrect because the auditor improperly used information and violated The IIA Code of Ethics. Some action is warranted.

30. During an examination of grants awarded by a nonprofit organization, an internal auditor discovered a number of grants made without the approval of the grant authorization committee (which includes outside representatives), as required by the organization's charter. All the grants, however, were approved and documented by the president. The chair of the grant authorization committee, who is also a member of the board of directors, proposes that the committee meet and retroactively approve all the grants before the engagement communication is issued. If the committee meets and approves the grants before such issuance, the internal auditor should

A. Not report the grants in question because they were approved before the issuance of the engagement communication.

B. Discuss the matter with the chair of the grant committee to determine the rationale for not approving the grants earlier. If the grants are routine, discussion of the grant committee's inaction should be omitted from the engagement communication.

C. Include the items in the communication as an override of the organization's controls. Details about each grant should be reported, and the internal auditor should investigate further for fraud.

D. Report the override of control to the board.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The action by an internal auditor if the committee retroactively authorizes certain grants.

DISCUSSION: Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." The management override of an important control over approval of grants created a material risk exposure. Thus, the internal auditor is ethically obligated to report the matter to senior officials charged with performing the governance function.

Answer (A) is incorrect because the control override should be reported. Answer (B) is incorrect because the routine nature of the grants is irrelevant to the issue of the violation of the charter. Answer (C) is incorrect because details about each grant need not be included unless the internal auditor believes that fraud may have occurred. Moreover, the appropriate organizational authorities should be informed if wrongdoing is suspected.

31. In a review of travel and entertainment expenses, a certified internal auditor questioned the business purposes of an officer's reimbursed travel expenses. The officer promised to compensate for the questioned amounts by not claiming legitimate expenses in the future. If the officer makes good on the promise, the internal auditor

A. Can ignore the original charging of the non-business expenses.

B. Should inform the tax authorities in any event.

C. Should still include the finding in the final engagement communication.

D. Should recommend that the officer forfeit any frequent flyer miles received as part of the questionable travel.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The internal auditor's action when an officer agrees to compensate for questionable expenses by not claiming legitimate expenses in the future.

DISCUSSION: Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

Answer (A) is incorrect because the possibly fraudulent behavior of the officer is a material fact that should be reported regardless of whether the questioned expenses are reimbursed. Answer (B) is incorrect because the Standards require the CAE to disseminate results to the appropriate individuals (Standard 2440). However, communication of results outside the organization is not required in the absence of a legal mandate. Answer (D) is incorrect because management should determine what constitutes just compensation.

32. An internal auditor, nearly finished with an engagement, discovers that the director of marketing has a gambling habit. The gambling issue is not directly related to the existing engagement, and the internal auditor is under pressure to complete it quickly. The internal auditor notes the problem and passes the information on to the chief audit executive but does no further follow-up. The internal auditor's actions

A. Are in violation of The IIA Code of Ethics for withholding meaningful information.

B. Are in violation of the Standards because the internal auditor did not properly follow up on a red flag that might indicate the existence of fraud.

C. Are not in violation of either The IIA Code of Ethics or the Standards.

D. Are in violation of The IIA Code of Ethics for withholding meaningful information and are in violation of the Standards because the internal auditor did not properly follow up on a red flag that might indicate the existence of fraud.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The true statement(s) about an internal auditor's communication of personal information about an engagement client.

DISCUSSION: There is no violation of either The IIA Code of Ethics or the Standards. The internal auditor did not withhold information, but rather, properly followed up upon learning of the information.

33. An engagement at a foreign subsidiary disclosed payments to local government officials in return for orders. What action does The IIA Code of Ethics suggest for an internal auditor in such a case?

A. Refrain from any action that might be detrimental to the organization.

B. Report the incident to appropriate regulatory authorities.

C. Inform appropriate organizational officials.

D. Report the practice to the board of The Institute of Internal Auditors.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The internal auditor's action after learning of payments to foreign officials in return for orders.

DISCUSSION: Such payments may be illegal. Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

Answer (A) is incorrect because informing organizational officials is not detrimental to the organization. Answer (B) is incorrect because the Code does not require that the incident be reported to regulatory authorities. Answer (D) is incorrect because the Code does not require reporting the The IIA.

34. During an engagement performed at a manufacturing division of a defense contractor, the internal auditor discovered that the organization apparently was inappropriately adding costs to a cost-plus governmental contract. The internal auditor discussed the matter with senior management, which suggested that the internal auditor seek an opinion from legal counsel. Upon review, legal counsel indicated that the practice was questionable but was not technically in violation of the government contract. Based on legal counsel's decision, the internal auditor decided to omit any discussion of the practice in the final engagement communication sent to senior management and the board. However, the internal auditor did informally communicate legal counsel's decision to senior management. Did the internal auditor violate The IIA's Code of Ethics?

A. No. The internal auditor followed up the matter with appropriate personnel within the organization and reached a conclusion that no fraud was involved.

B. No. If a fraud is suspected, it should be resolved at the divisional level where it is taking place.

C. Yes. It is a violation because all important information, even if resolved, should be reported to the board.

D. Yes. Internal legal counsel's opinion is not sufficient. The internal auditor should have sought advice from outside legal counsel.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The reason, if any, for a violation of The IIA's Code of Ethics.

DISCUSSION: Although an argument can be made that the internal auditor should report the matter to the board and senior management, there is no indication that the internal auditor is deliberately withholding material facts that, if not disclosed, may distort reports of activities under review (Rule of Conduct 2.3). Hence, no violation of the Code occurred.

Answer (B) is incorrect because material fraud, if suspected, should be brought to the attention of management. However, in this case, the internal auditor gathered sufficient information to dispel the suspicion of fraud. Answer (C) is incorrect because the internal auditor did not deliberately withhold important information. Answer (D) is incorrect because the internal auditor has gathered sufficient information. Internal legal counsel's opinion appears to be sufficient.

35. During an engagement, an employee with whom you have developed a good working relationship informs you that she has some information about senior management that is damaging to the organization and may concern illegal activities. The employee does not want her name associated with the release of the information. Which of the following actions is considered to be inconsistent with The IIA Code of Ethics and Standards?

A. Assure the employee that you can maintain her anonymity and listen to the information.

B. Suggest that the employee consider talking to legal counsel.

C. Inform the employee that you will attempt to keep the source of the information confidential and will look into the matter further.

D. Inform the employee of other methods of communicating this type of information.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The action inconsistent with The IIA Code of Ethics and the Standards.

DISCUSSION: An internal auditor cannot guarantee anonymity. Information communicated to an internal auditor is not subject to a testimonial privilege. Moreover, Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review." The identity of the informant may be such a material fact.

Answer (B) is incorrect because suggesting that the person seek expert legal advice from a qualified individual is appropriate. Answer (C) is incorrect because promising merely to attempt to keep the source of the information confidential is allowable. This promise is not a guarantee of confidentiality. Answer (D) is incorrect because the employee could be directed to other methods of communicating the information in order to maintain her anonymity.

36. The chief audit executive is aware of a material inventory shortage caused by internal control deficiencies at one manufacturing plant. The shortage and related causes are of sufficient magnitude to affect the external auditor's report. Based on The IIA Code of Ethics, what is the CAE's most appropriate course of action?

A. Say nothing; guard against interfering with the independence of the external auditors.

B. Discuss the issue with management and take appropriate action to ensure that the external auditors are informed.

C. Inform the external auditors of the possibility of a shortage but allow them to make an independent assessment of the amount.

D. Communicate the shortages to the board and allow them to communicate it to the external auditor.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The most appropriate action given awareness by the CAE of a matter affecting the external auditor's report.

DISCUSSION: The IIA's Code of Ethics calls for compliance with the Standards (Rule of Conduct 4.2). The CAE should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services (Standard 2050). In addition, all material facts known by the internal auditors should be disclosed (Rule of Conduct 2.3). Because the shortage affects the external auditor's work, in which the internal auditors are participating, the situation must be divulged.

Answer (A) is incorrect because the shortage is a material fact that could distort a report of activities under review if not revealed. Answer (C) is incorrect because the condition is known and the external auditors should be told more than that a possibility of a shortage exists. Answer (D) is incorrect because information should be shared and activities coordinated with the external auditor.

37. Through an engagement performed at the credit department, the chief audit executive (CAE) became aware of a material misstatement of the year-end accounts receivable balance. The external auditors have completed their engagement without detecting the misstatement. What should the CAE do in this situation?

A. Inform the external auditors of the misstatement.

B. Report the misstatement to management when the external auditors present a report.

C. Exclude the misstatement from the final engagement communication because the external auditors are responsible for expressing an opinion on the financial statements.

D. Perform additional engagement procedures on accounts receivable balances to benefit the external auditors.

Answer (A) is correct. *(CIA, adapted)*

REQUIRED: The proper action by the CAE after discovery of a material misstatement not found by the external auditor.

DISCUSSION: Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

Answer (B) is incorrect because the CAE should share information and coordinate activities with the external auditors (Standard 2050). Answer (C) is incorrect because, although the internal audit activity's main focus may be on risk management, control, and governance processes, a material misstatement must be communicated. Answer (D) is incorrect because, when performing an audit, the external auditors should determine what work should be performed by the internal auditor.

38. Which of the following most likely constitutes a violation of The IIA's Code of Ethics?

A. Janice has accepted an assignment to perform an engagement at the electronics manufacturing division. Janice has recently joined the internal audit activity. But she was senior auditor for the external audit of that division and has audited many electronics organizations during the past 2 years.

B. George has been assigned to perform an engagement at the warehousing function 6 months from now. George has no expertise in that area but accepted the assignment anyway. He has signed up for continuing professional education courses in warehousing that will be completed before his assignment begins.

C. Jane is content with her career as an internal auditor and has come to look at it as a regular 9-to-5 job. She has not engaged in continuing professional education or other activities to improve her effectiveness during the last 3 years. However, she feels she is performing the same quality work she always has.

D. John discovered an internal financial fraud during the year. The books were adjusted to properly reflect the loss associated with the fraud. John discussed the fraud with the external auditor when the external auditor reviewed working papers detailing the incident.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The violation of The IIA's Code of Ethics.

DISCUSSION: Rule of Conduct 4.3 states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services."

Answer (A) is incorrect because no professional conflict of interest exists per se, especially given that the internal auditor was previously in public accounting. However, the internal auditor should be aware of potential conflicts. Answer (B) is incorrect because, according to Rule of Conduct 4.1, "Internal auditors shall engage only in those services for which they have the necessary knowledge, skills, and experience." Thus, George may perform this service if he has the necessary knowledge, etc. Answer (D) is incorrect because the information was disclosed as part of the normal process of cooperation between the internal and external auditor. Because the books were adjusted, the external auditor was expected to inquire as to the nature of the adjustment.

39. An internal auditor has uncovered facts that could be interpreted as indicating unlawful activity on the part of an engagement client. The internal auditor decides not to inform senior management and the board of these facts because of lack of proof. The internal auditor, however, decides that, if questions are raised regarding the omitted facts, they will be answered fully and truthfully. In taking this action, the internal auditor

A. Has not violated The IIA Code of Ethics or the Standards because confidentiality takes precedence over all other standards.

B. Has not violated The IIA Code of Ethics or the Standards because the internal auditor is committed to answering all questions fully and truthfully.

C. Has violated The IIA Code of Ethics because unlawful acts should have been reported to the appropriate regulatory agency to avoid potential "aiding and abetting" by the internal auditor.

D. Has violated the Standards because the internal auditor should inform the appropriate authorities in the organization if fraud may be indicated.

Answer (D) is correct. *(CIA, adapted)*

REQUIRED: The effect of not reporting a suspected irregularity.

DISCUSSION: The internal auditor should inform the appropriate authorities in the organization if the indicators of the commission of a fraud are sufficient to recommend an investigation. Hence, the internal auditor has a duty to act even though the available facts do not prove that an irregularity has occurred. Moreover, Rule of Conduct 2.3 states, "Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review."

Answer (A) is incorrect because reporting a possible irregularity to the appropriate organizational authorities is not a breach of the duty of confidentiality owed to the organization. Answer (B) is incorrect because the internal auditor has an affirmative duty to report the results of his/her work. Answer (C) is incorrect because the possibility of unlawful activities should be reported to the appropriate personnel within the organization.

40. Internal auditors who fail to maintain their proficiency through continuing education could be found to be in violation of

A. *The Standards for the Professional Practice of Internal Auditing*.

B. The IIA's Code of Ethics.

C. Both the Standards for the Professional Practice of Internal Auditing and The IIA's Code of Ethics.

D. None of the answers are correct.

Answer (C) is correct. *(CIA, adapted)*

REQUIRED: The effect of failing to meet continuing education requirements.

DISCUSSION: The IIA's Code of Ethics (Rule of Conduct 4.3) states, "Internal auditors shall continually improve their proficiency and the effectiveness and quality of their services." The Code also requires compliance with the SPPIA (Rule of Conduct 4.2). Furthermore, Standard 1230 states, "Internal auditors should enhance their knowledge, skills, and competencies through continuing professional development." Hence, both The IIA's Code of Ethics and the SPPIA are violated by failing to earn continuing education credits.

41. Today's internal auditor will often encounter a wide range of potential ethical dilemmas, not all of which are explicitly addressed by The IIA's Code of Ethics. If the internal auditor encounters such a dilemma, the internal auditor should always

A. Seek counsel from an independent attorney to determine the personal consequences of potential actions.

B. Apply and uphold the principles embodied in The IIA Code of Ethics.

C. Seek the counsel of the board before deciding on an action.

D. Act consistently with the code of ethics adopted by the organization even if such action is not consistent with The IIA's Code of Ethics.

Answer (B) is correct. *(CIA, adapted)*

REQUIRED: The action taken when an internal auditor encounters an ethical dilemma.

DISCUSSION: The Code includes Principles (integrity, objectivity, confidentiality, and competency) relevant to the profession and practice of internal auditing and Rules of Conduct that describe behavioral norms for internal auditors and that interpret the Principles. Internal auditors are expected to apply and uphold the Principles. Furthermore, that a particular conduct is not mentioned in the Rules does not prevent it from being unacceptable or discreditable.

Answer (A) is incorrect because seeking the advice of legal counsel on all ethical decisions is impracticable. Answer (C) is incorrect because seeking the advice of the board on all ethical decisions is impracticable. Furthermore, the advice might not be consistent with the profession's standards. Answer (D) is incorrect because, if the organization's standards are not consistent with, or as high as, the profession's standards, the internal auditor is held to the standards of the profession.

42. Which of the following actions should not be taken initially when credible evidence exists that the corporation is unnecessarily exposing itself to risk?

A. The chief audit executive may discuss his or her concerns about the risk exposure with senior management within his or her normal chain of command.

B. The chief audit executive may discuss his or her concerns about the risk of exposure with the board of directors.

C. The chief audit executive may discuss his or her concerns with the parties responsible for the risk exposure.

D. The chief audit executive may discuss his or her concerns with someone outside the organization.

Answer (D) is correct. *(Publisher)*

REQUIRED: The communication of sensitive information by the chief audit executive.

DISCUSSION: Practice Advisory 2440-3 states that if the internal auditor has credible evidence of exposure to an unnecessary risk, the auditor should normally communicate the information to those in management who can act on it. If the chief audit executive is not satisfied with the result, then other options are available. The chief auditor could discuss his or her concerns with senior management, which often includes members of the board of directors. The chief audit executive should only consider discussion with outside parties if he or she believes that management will not investigate the issue properly and other people may be adversely affected.

Answer (A) is incorrect because discussion with senior management is often one of the first actions taken by the chief audit executive when risks are exposed. Answer (B) is incorrect because the board of directors is normally within the chief audit executive's chain of command, and the chief audit executive is likely to bring up risk exposures to the board of directors. Answer (C) is incorrect because the chief audit executive may believe that the problem can be solved quickly by discussing the issue with those directly responsible for the risk exposure.

43. In which of the following scenarios must the chain of command discussions be accelerated?

A. A manager is not taking adequate steps to protect a patent developed by the corporation.

B. A publicly traded corporation is hiding its liabilities in off-balance-sheet entities.

C. Activities that the corporation engages in may result in environmental damage in the future.

D. Several significant investments held by the corporation are being mismanaged by the corporation.

Answer (B) is correct. *(Publisher)*

REQUIRED: The scenario in which the chain of command discussions should be accelerated.

DISCUSSION: Situations involving fraudulent financial reporting by a company with publicly traded securities should be brought to the attention of the audit committee of the board of directors immediately. This action must be taken even if the chief audit executive and management agree on a course of action.

Answer (A) is incorrect because the manager's lack of action affects the corporation's competitiveness and success but would not require the chain of command discussions to be accelerated. Corrective action may be taken before the issue is brought before the board of directors. Answer (C) is incorrect because, although this is an issue that management will have to address in the future, it does not force the acceleration of the chain of command discussions. Answer (D) is incorrect because mismanagement of funds may be corrected at lower levels in the corporation. Although the misallocation of resources may result in losses, it does not require the acceleration of the chain of command discussions.

44. Which of the following is not an example of "whistleblowing?"

A. Informing the chief executive officer about a manager who engages in fraudulent related party transactions.

B. Telling the manager of a different department about illegal elimination of toxic wastes by the corporation.

C. Exposing an unsafe working environment to OSHA.

D. Writing a letter to a newspaper about illegal hiring practices of the corporation.

Answer (A) is correct. *(Publisher)*

REQUIRED: The scenario that is not whistleblowing.

DISCUSSION: Some situations may cause the internal auditor to consider whether to discuss sensitive information with people outside the normal chain of command or people outside of the corporation. Whistleblowing is defined as the act of disclosing adverse information to someone in the organization who is outside of the individual's normal chain of command, or to a governmental agency or other authority that is wholly outside of the organization (Practice Advisory 2440-3).

Answer (B) is incorrect because whistleblowing includes telling anyone outside of the chain of command even if they are still within the organization. Answer (C) is incorrect because disclosure of adverse information to a governmental agency is considered whistleblowing. Answer (D) is incorrect because the disclosure of adverse information to an party outside the organization is considered whistleblowing.

45. For which situation should the internal auditor consider communicating sensitive information outside the organization's governance structure?

A. The internal auditor believes the corporation does not have the resources to address the problem efficiently.

B. Action by management may take longer than the internal auditor believes is necessary to correct the problem.

C. The internal auditor believes that the problem will not be properly investigated by management.

D. An outside agency may be able to help the corporation correct the problem faster than the corporation could on its own.

Answer (C) is correct. *(Publisher)*

REQUIRED: The situation in which sensitive information should be discussed outside the organization's governance structure.

DISCUSSION: In most cases of whistleblowing, whistleblowers will disclose sensitive information internally, even if not within the normal chain of command, if they trust the policies and mechanisms of the organization to investigate the problem. If the whistleblower doubts the problem will be properly investigated by the corporation, (s)he may consider disclosing the problem to an outside party.

Answer (A) is incorrect because management and the board of directors may still take corrective action and seek outside assistance if they believe it is necessary. Revealing sensitive information prematurely would put the corporation at an unnecessary risk. Answer (B) is incorrect because management is taking appropriate action and the internal auditor should work with management and the board of directors to correct problems before involving an outside party. Answer (D) is incorrect because management and the board of directors have the responsibility to decide how to handle the problem. If management or the board of directors believes that an outside party should be consulted, management and the board of directors may make that decision.

46. Which of the following should not be one of the primary reasons why an internal auditor may communicate sensitive information outside the normal chain of command?

A. The desire to stop the wrongful, harmful, or improper activity.

B. Legal advice indicates that the internal auditor should disclose the sensitive information to an outside party.

C. A professional obligation requires disclosure of the activity to an outside party.

D. The internal auditor does not agree with how the board or directors or management may correct the problem.

Answer (D) is correct. *(Publisher)*

REQUIRED: The item not a primary reason an internal auditor should disclose sensitive information to an outside party.

DISCUSSION: The choice to disclose sensitive information is a personal choice. The decision to communicate outside the normal chain of command should be based on a well-informed opinion that the wrongdoing is supported by credible evidence and that a legal or professional obligation requires further action. The internal auditor's motive for outside disclosure should be the desire to stop the wrongful, harmful, or improper activity.

Answer (A) is incorrect because the primary motive of outside disclosure to get management or the board of directors to stop the activity they are engaged in. Answer (B) is incorrect because the internal auditor will often consult legal counsel before deciding what course of action to take with regard to the activity. Answer (C) is incorrect because a professional obligation often forces the internal auditor to disclose to outside parties. The IIA Code of Ethics requires IIA members and certified internal auditors to adhere to the disclosure requirements of illegal or unethical acts.