PART I

Foundations of Modern Internal Auditing

CHAPTER **1**

Foundations of Internal Auditing

The profession of auditing has been with us for a long time. Based on stone documents that have been found, historians have determined that in about 3000 B.C., scribes of Mesopotamian civilizations utilized elaborate systems of internal controls using ticks, dots, and check marks. Auditing has evolved over the millennia, and today we generally think of two basic types of business auditors: external and internal. An external auditor is chartered by regulatory authority to visit an enterprise or entity and to review and independently report the results of that review. In the United States, most external auditors are known as Certified Public Accountants (CPAs), who are state licensed and follow the standards of the American Institute of Certified Public Accountants (AICPA; see aicpa.org). However, there are other types of external auditors in fields such as medical equipment devices, television viewer ratings, and various governmental areas.

Internal auditing is a broader and often more interesting field. As an employee or member of an enterprise, an internal auditor independently reviews and assesses operations in a wide variety of areas, such as accounting office procedures or manufacturing quality processes. Most internal auditors follow high-level standards established by their professional enterprise, the Institute of Internal Auditors (IIA; see theiia.org), but there are many different practices and approaches to internal auditing today due to its worldwide nature and many types of auditing activities.

The prime objective of this book is to define and describe internal auditing as it is performed today—modern internal auditing—and to describe a common body of knowledge (CBOK) for all of internal auditing. Because of its many variations and nuances, we are describing and discussing modern internal auditing in terms of these CBOK, key tools, and knowledge areas that all internal auditors should at least know. These are the common practices that are essential to the profession of modern internal auditing.

An effective first step to begin to understand internal auditing and its key knowledge areas is to refer to its professional organization, the IIA, and its published professional standards. The IIA defines the practice of internal auditing in this way:

> *Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.*

This statement becomes more meaningful when one focuses on its key terms. *Auditing* suggests a variety of ideas. It can be viewed very narrowly, such as the checking of arithmetical accuracy or physical existence of accounting records, or more broadly, as a thoughtful review and appraisal at the highest organizational

level. Throughout this book, the term *auditing* will be used to include this total range of levels of service, from detailed checking to higher level appraisals. The term *internal* defines work carried on within an enterprise, by its own employees, not by external auditors, outside public accountants or other parties, such as government regulators, who are not directly a part of the particular enterprise or enterprise.

The remainder of the IIA's definition of internal auditing covers a number of important terms that apply to the profession.

- The term *independent* is used for auditing that is free of restrictions that could significantly limit the scope and effectiveness of any internal auditor review or the later reporting of resultant findings and conclusions.
- The word *appraisal* confirms the need for an evaluation that is the thrust of internal auditors as they develop their conclusions.
- The term *established* confirms that internal audit is a formal, definitive function in the modern enterprise.
- The phrase *examine and evaluate* describes the active roles of internal auditors, first for fact-finding inquiries and then for judgmental evaluations.
- The term *its activities* confirm the broad jurisdictional scope of internal audit work that applies to all of the activities of the modern enterprise.
- The word *service* reveals that the help and assistance to the audit committee, management, and other members of the enterprise are the end products of all internal auditing work.
- The phrase *to the organization* confirms that internal audit's total service scope pertains to the entire enterprise, including all personnel, the board of directors and their audit committee, stockholders, and other owners.

As a small point, we generally use the term *enterprise* to refer the whole company or business and the term *organization* or *function* to refer to an individual department or unit within an enterprise. In the chapters to come, we describe a variety of other terminology and usage conventions as we discuss a CBOK for modern internal auditing.

Internal auditing should also be recognized as an organizational control within an enterprise that functions by measuring and evaluating the effectiveness of other controls. When an enterprise establishes its planning and proceeds to implement its plans in terms of operations, it must monitor the operations to assure the achievement of its established objectives. These further efforts can be thought of as *controls*. Although the internal audit function is itself one of the types of controls used, there is a wide range of other function-level controls. The special role of internal audit is to help measure and evaluate those other controls. Thus, internal auditors must understand both their own role as a control function and the nature and scope of other types of controls in the overall enterprise.

Internal auditors who do their job effectively become experts in what makes for the best possible design and implementation of all types of controls and preferred practices. This expertise includes understanding the interrelationships of various controls and their best possible integration in the total system of internal control. It is thus through the internal control door that internal auditors come to examine and evaluate all organization activities and to provide maximum service to the enterprise. Internal auditors cannot be expected to equal—let alone exceed—the technical and

operational expertise of the many specialized activities of an enterprise. However, internal auditors can help the responsible individuals achieve more effective results by appraising existing controls and providing a basis for helping to improve those controls. In addition, because internal auditors often have a good knowledge and understanding of many organizational units within a total enterprise, their levels of understanding often exceed that of many other people.

1.1   Internal Auditing History and Background

It is normal for any activity—including a control activity such as internal auditing—to come into being as a result of emerging needs. Although it has ancient roots, internal auditing was not recognized as an important process by many enterprises and their external auditors until the 1930s. This recognition was primarily due to the establishment of the U.S. Securities and Exchange Commission (SEC) in 1934 and changing external audit objectives and techniques at that time. The United States and the rest of the world had just gone through a major economic depression. As a legislative corrective action, the SEC required that enterprises registered with it must provide financial statements certified by independent auditors. This requirement prompted corporations to establish internal auditing departments, the main purpose of which was to assist their independent auditors. At that time, external financial auditors were focusing on expressing an opinion on the fairness of an enterprise's financial statements rather than on detecting internal control weaknesses or even clerical errors. The SEC rules precipitated auditing based on a limited sample of transactions, along with greater reliance on internal control procedures.

Also at that time, internal auditors were primarily concerned with checking accounting records and detecting financial errors and irregularities and often were little more than shadows or assistants to their independent external auditors. Walter B. Meigs, writing about the status of internal auditors during the 1930s, observed that "internal auditors were either clerks assigned to the routine task of a perpetual search for clerical errors in accounting documents, or they were traveling representatives of corporations having branches in widely scattered locations."[1] Early internal auditors were often little more than clerical helpers who carried out routine accounting reconciliations or served as clerical support personnel. Vestiges of this old definition of internal auditing continued in some places even into the early 1970s. For example, in many retail organizations in the late 1960s, the "auditors" were the people who balanced cash registers (remember those?) at the close of the business day.

Although other voices said something should be done to improve and better utilize the potential of internal auditors, things really got started after Victor Z. Brink completed his college thesis on the need for modern internal auditing before he went off to serve in World War II. After the war ended, Brink returned to organize and head internal auditing for Ford Motor, and his college thesis was published as the now long-out-of-print first edition of this *Modern Internal Auditing*.

About that same time period and in 1942, the IIA was launched. Its first membership chapter was started in New York City, with Chicago soon to follow. The IIA was formed by people who had been given the title of internal auditor by their enterprises and who wanted to both share their experiences and gain knowledge with others in this new professional field. A profession was born then that has

undergone many changes over the years and has resulted in the multifaceted profession of modern internal auditor discussed in this book.

The business enterprise of 1940s, when modern internal auditing was just getting started, required a very different skill set than do businesses today. For example, aside from some electromechanical devices and activities in research laboratories, digital computer systems did not exist. Enterprises had no need for computer programmers until computers started to become useful for record-keeping and other computational and accounting functions. Similarly, enterprises had very rudimentary telephone connections; switchboard operators routed all incoming calls to a limited number of desktop telephones. Today, we are all connected through a vast, automated worldwide web of telecommunications and the Internet. The increasing complexity of modern business and other enterprises has created the need for internal auditors to become specialists in various business controls. We can also better understand the nature of internal auditing today if we know something about the changing conditions in the past and the different needs these changes created. What is the simplest or most primitive form of internal auditing and how did it come into existence? How has internal auditing responded to changing needs?

At its most primitive level, a self-assessment or internal auditing function can exist when any single person sits back and surveys something that he or she has done. At that point, the individual asks him- or herself how well a particular task has been accomplished and, perhaps, how it might be done better if it were to be done again. If a second person is involved in this activity, the assessment function would be expanded to include an evaluation of that second person's participation in the endeavor. In a small business, the owner or manager will be doing this review to some extent for all enterprise employees. In all of these situations, the assessment or internal audit function is being carried out directly as a part of a basic management role. However, as the operations of an enterprise become more voluminous and complex, it is no longer practicable for the owner or top manager to have enough contact with all operations to satisfactorily review the effectiveness of enterprise performance. These responsibilities need to be delegated.

Although this hypothetical senior manager could build a supervisory system to try to provide a personal overview of operations, as the enterprise grows larger and more complex, that same manager will find it increasingly difficult to know whether the interests of the enterprise are being properly served. Are established procedures being complied with? Are assets being properly safeguarded? Are the various employees functioning efficiently? Are the current approaches still effective in the light of changing conditions?

The manager must obtain further help by assigning one or more individuals to be directly responsible for reviewing activities and reporting on the types of questions just mentioned. It is here that the internal auditing activity comes into being in a formal and explicit sense. The first internal auditing assignments were usually originated to satisfy very basic and sharply defined operational needs. The earliest special concerns of management was whether the assets of the enterprise were being properly protected, whether company procedures and policies were being complied with, and whether financial records were being accurately maintained. There was also considerable emphasis on maintenance of the status quo. To a great extent, this early internal auditing effort can be viewed as a closely related extension of the work of external auditors.

The result of all of these factors was that the early internal auditors were viewed as playing a narrow role in their enterprises, with relatively limited responsibility in the total managerial spectrum. Their body of knowledge needs was increasing. An early internal auditor was viewed as a financially oriented checker of records and more of a "police officer" than a coworker. In some enterprises, internal auditors had major responsibilities for reconciling canceled payroll checks with bank statements or checking the mathematics in regular business documents. As mentioned, internal auditors in many retail enterprises often were responsible for reconciling daily cash sales to recorded sales receipts.

Understanding the history of internal auditing is important because the old image of internal auditors still exists, to some extent, in various places in the world, even though the character of the internal auditing function is now very different. Over a period of time, the operations of various enterprises increased in volume and complexity, creating managerial problems and new pressures on senior management. In response to these pressures, many senior managers recognized the possibilities for better utilization of their internal auditors. Here were individuals already set up in an enterprise internal audit function, and it seemed possible to get greater value from them with relatively little increase in cost.

At the same time, internal auditors recognized these opportunities and initiated new types of services themselves. Thus, internal auditors gradually took on broader and more management-oriented responsibilities in their work efforts. Because internal auditing was largely accounting oriented at first, this trend was felt first in the accounting and financial control areas. Rather than just report the same accounting-related exceptions—such as some item of documentation lacking a supervisor's initial—internal auditors began to question the overall control processes they were reviewing. Subsequently, internal audit valuation work began to be extended to include many nonfinancial areas in the enterprise.

New business initiatives in the United States, such as the Committee of Sponsoring Organizations (COSO) internal control framework discussed in Chapter 3 or the Sarbanes-Oxley Act (SOx) highlighted in Chapter 4, have caused a continuing increase in the need for the services of internal auditors. In addition, some newer environmental forces have created needs in such areas as protection from industrial hazards, support of quality-control programs, and different levels of business responsibility, including ethical standards. This need for ethical standards includes higher standards for corporate governance, greater involvement of boards of directors and their audit committees, a more active role for stockholders, and greater independence of outside public accountants.

Ethics and social responsibility issues are discussed in Chapter 24. As a result of these new pressures, the services of internal auditors have become more important to all interested parties. There are now more and better-qualified internal auditing personnel and a higher level of enterprise status and importance attached to the position. The IIA has grown from its first, 25-member charter chapter in 1942, to an international association with over 90,000 members and hundreds of local chapters worldwide. At the same time, the importance of internal audit has been recognized by external auditors through their auditing standards, as discussed in Chapter 8. The internal audit profession has reached a major level of maturity and is well positioned for continuing dynamic growth.

Internal auditing today involves a broad spectrum of types of operational activity and levels of coverage. Internal auditing has moved beyond being a staff activity

roughly tied to the controller's department, and internal audit's role is constantly being redefined. SOx has been a major driver of change for internal auditors in the United States and then worldwide. While internal auditors once had a nominal reporting relationship to the board's audit committee, SOx has strengthened and formalized that reporting relationship. However, in some other enterprises, internal audit continues to function at just a routine compliance level. In other situations, internal audit still is integrated too closely with regular accounting activities and limits virtually all of its audit work to strictly financial areas. These exceptions do not reflect the potential capabilities of modern internal auditors. They may also reflect the lack of progressive attitudes in the overall enterprise.

Today, internal audit has expanded its activities to all operational areas of the enterprise and has established itself as a valued and respected part of the senior management effort. The modern internal auditor is formally and actively serving the board of director's audit committee, and the chief audit executive (CAE) today has direct and active level of communication with that same audit committee. This situation reflects major progress in the scope of internal audit's coverage and level of service to all areas of the enterprise. The internal auditing profession itself, through its own self-development and dedication, has contributed to this progress and has set the stage for a continuing upward trend.

1.2   Organization of This Book

The overall object of this book is to define the practice of modern internal auditing as it exists today and to describe a common body of knowledge for the profession. While we generally think of an internal auditor as a professional affiliated with the IIA and its standards, an internal auditor is really a larger, broader person today. Many enterprises have a parallel—almost a shadow—group of quality auditors following the internal audit standards of the American Society for Quality (ASQ; see asq.org). These are internal auditors with different objectives but similar approaches to IIA-background internal auditors; we should see greater convergence between IIA and ASQ internal auditors in the years to come.

The mission and objective of this book and its 34 chapters is to define the practice of modern internal auditing today and to describe an internal audit CBOK. Relying on the internal auditing insights and a heritage, going back to Victor Brink's earliest editions, but with a focus on new and evolving trends and technologies, the chapters of this book are organized in eight parts:

Part One: Foundations of Modern Internal Auditing. Going beyond our discussion on the background of internal auditing discussed here, Chapter 2 discusses the importance of an internal audit CBOK, the expressed needs of the IIA to build such a CBOK, and similar experiences in other professions. In addition, we summarize our chapter-by-chapter CBOK elements.

Part Two: Importance of Internal Controls. The review and understanding of internal control is a major internal audit strength. Chapters in this part discuss the COSO's internal control framework and the internal control aspects of the SOx. Our SOx material highlights the new external auditing standards, called Auditing Standard No. 5 (AS 5). In addition, we highlight

the importance of what is known as the *C*ontrol *ob*jectives for *i*nformation and related *T*echnology (CobiT) framework as a vehicle for understanding internal controls.

Part Three: Planning and Performing Internal Audits. This part covers the overall process of performing internal audits with an introduction of the international IIA's internal auditing standards and guidelines for performing effective internal audits. Chapters here discuss the process of assessing and evaluating audit evidence as well as documenting audit results, with an emphasis on electronic flowcharts and workpapers.

Part Four: Organizing and Managing Internal Audit Activities. An effective internal audit function requires a well-planned and organized audit function that selects appropriate areas for audit, based on their relative risk. Chapters in this part discuss approaches to building an effective internal audit organization, understanding key competency needs, and risk-based audit planning. Chapters also discuss the very important area of project management as well as process modeling for internal auditors. This part includes the very important area of reporting internal audit results.

Part Five: Impact of Information Systems on Internal Auditing. Information systems or information technology (IT) has a major impact on the areas where internal auditors perform reviews as well as tools to assist the internal audit process. The five chapters in this part describe procedures for internal audit reviews of IT controls on multiple levels. IT-related security and continuity planning procedures are discussed, as well as computer-assisted audit tools and techniques (CAATTs) to help perform more effective internal audits.

Part Six: Internal Audit and Enterprise Governance. Internal audit has a major role today in helping to build a more effective corporate governance environment. This includes understanding and monitoring compliance with many of the new rules that enterprises face today, helping to build a better ethics atmosphere, and focusing some audit work on fraud detection and prevention. Perhaps most important, Chapter 23 in this part discusses how internal audit can better serve and assist the audit committee of the board of directors.

Part Seven: The Professional Internal Auditor. The professional designations of Certified Internal Auditor (CIA) and Certified Internal Systems Auditor (CISA) are very important for internal audit professionals. Chapter 27 discusses the requirements of these as well as some other important internal auditor professional achievements. In addition, other chapters in this part introduce the advanced auditing technique of continuous assurance auditing as well as the role of internal auditors as internal enterprise consultants.

Part Eight: Internal Auditing Professional Convergence CBOK Requirements. This part looks at the ASQ internal audit process, reviews of quality systems standards, and techniques such as six sigma. This part and the book conclude with an introduction to worldwide audit standards, our CBOK, and the future modern internal auditor.

The chapters in this edition define a professional internal auditor CBOK and discuss the roles and responsibilities of today's modern internal auditor. Even though

past editions covered a wide range of areas, in this volume, subjects and topics have been organized with this internal audit CBOK as a theme. It is our objective that the materials in the chapters to come will help all internal auditors to gain knowledge and expertise in their profession and for management and others to better understand the practice of modern internal auditing.

Note

1. Walter B. Meigs, *Accounting Review* 35, No. 2 (April 1960): 377.