PART I

Internal Audit and Quality

CHAPTER 1

The Various Faces of Internal Audit

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.

—Institute of Internal Auditors, Definition of *Internal Auditing* (2013)

Internal auditing is an internationally recognized profession guided by a common commitment to enhancing governance, risk management, and control processes. Although the nature of internal auditing may vary between countries, jurisdictions, and organizations, central to its purpose is a desire to support management to improve operational, and ultimately organizational, outcomes.

There is no single correct approach to internal auditing. Internal auditing should look and feel different for each organization. The best internal audit functions will reflect the priorities and values of each organization. Senior managers and audit committees across organizations will each have their own expectations of the internal audit function. The challenge for chief audit executives is to understand and, wherever possible, reflect these expectations in their operations.

History

Internal auditing can be traced back to the Persian Empire. Murray (1976) attributes the start of internal auditing to Darius the Great, "who ruled his people from 521 to 425 B.C." Darius exercised his rule at different times of the year from four scattered capitals in different parts of the country—Persepolis, Ecbatana, Susa, and Ctesiphon. His empire was divided into 20 provinces, each administered by a *satrap* who paid taxes to the empire according to the wealth of the province. In order that the honesty of the rule of the satrap could be established, Darius sent representatives out to all parts of his empire. They became known as "the eyes and ears of the king"—possibly the first internal auditors.

Despite the early beginnings of internal auditing, the profession did not experience considerable growth until the nineteenth century, when the Industrial Revolution resulted in the large-scale systemization of processes, and an enhanced focus on quality and consistency of outputs. Its growth continued into the twentieth century with the development of management theory and practice and the emergence of the "manager" as a distinct role in corporate operations.

The Institute of Internal Auditors

The first major book on internal auditing was authored by Victor Brink in 1941. Around the same time, a small group of professionals were looking to establish a professional association for internal auditors.

The Institute of Internal Auditors (IIA) was established in the United States in 1941 with 24 members. The IIA developed a *Statement of Responsibilities of Internal Auditing* in 1947. According to Flesher (1996), the statement intended "that internal auditing dealt primarily with accounting and financial matters, but may also properly deal with matters of an operating nature. In other words, the emphasis was on accounting and financial matters, but other activities were also fair game for the internal auditor."

The role of the internal auditor was to evolve quickly, however, and as early as 1948, Byrne recognized the potential for internal audit to add value to organizations. He stated, "Management has broadened the internal auditor's horizons and it is the auditor's responsibility to take advantage of the opportunities presented in order to realize the true value to be obtained from a dynamic internal audit program" (Byrne 1948).

Flesher (1996) found the emphasis on accounting and finance matters in the IIA's 1947 statement had significantly changed by the release of a revised statement in 1957, which allowed the internal auditor to provide services to management, including:

- Reviewing and appraising the soundness, adequacy, and application of accounting, financial, and operating controls.
- Ascertaining the extent of compliance with established policies, plans, and procedures.
- Ascertaining the extent to which company assets are accounted for, and safeguarded from, losses of all kinds.
- Ascertaining the reliability of accounting and other data developed within the organization.
- Appraising the quality of performance in carrying out assigned responsibilities.

In 1978, the IIA released the *Standards for the Professional Practice of Internal Auditing*. The IIA established its first international chapters in 1948, and by 2012, membership had grown to over 180,000 across 190 countries.

According to its website, the mission of the IIA is to provide dynamic leadership for the global profession of internal auditing. The IIA has identified activities that support this mission:

- Advocating and promoting the value that internal audit professionals add to their organizations.
- Providing comprehensive professional educational and development opportunities, standards and other professional practice guidance, and certification programs.

- Researching, disseminating, and promoting knowledge concerning internal auditing and its appropriate role in control, risk management, and governance to practitioners and stakeholders.
- Educating practitioners and other relevant audiences on best practices in internal auditing.
- Bringing together internal auditors from all countries to share information and experiences.

The IIA is governed by a board of directors elected at an annual meeting of the membership. Under the board of directors sit a number of committees comprised primarily of volunteer members. Operationally, the IIA is supported through an office in the United States, which has a dual role of providing services directly to North American chapter members, as well as supporting a network of global institutes. Internationally, individual country institutes are often supported by their own office.

Types of Internal Audit Functions

Internationally, internal auditing is recognized as a profession with a number of common elements—most importantly, a set of recognized professional standards. However, the nature of internal auditing varies considerably between organizations.

Although most internal audit functions share a number of features, the nature of internal auditing will differ between public-sector organizations focused on the efficient and effective expenditure of public money and corporate entities focused on delivering profit to shareholders.

Internal auditing may also vary between countries and even states and regions within countries. Differences can be created or exacerbated by legislation, governance structures, cultures, language, and education systems.

Internal auditing takes on a different style and approach, depending on the nature of the audit work undertaken. In less-mature organizations, where there may be limited ability to rely on management to operate in accordance with agreed processes, the internal audit function may be focused on providing financial and control assurance. However, as organizations mature, and greater reliance can be placed on management, the internal audit function might operate more as a source of strategic advice and less as a compliance enforcer. These different types of roles and areas of responsibility are discussed further in Chapter 7.

Internal Auditing in Different Sectors and Organizations

Although internal auditing is an international profession, different countries, and jurisdictions within countries, have their own regulatory environments and cultures that affect the nature and operation of internal audit.

Likewise, the composition of the public sector, also referred to as public service or civil service, varies between, and even within, countries. Understandably then, the models for public-sector governance also vary. This has a direct impact on internal audit, and the configuration, roles, and responsibilities of internal audit functions. Some jurisdictions include mandatory requirements for internal audit and audit committees, while others operate on a voluntary basis.

Examples 1.1 to 1.6 illustrate differing jurisdictional approaches to internal audit.

Example 1.1 The Impact of the Sarbanes–Oxley Act on Internal Auditing in the United States

The *Sarbanes–Oxley Act* (SOX) (2002) has had a major influence on the role and nature of internal auditing in listed companies in the United States.

Section 404 of the act requires management's development and monitoring of procedures and controls for making its required assertion about the adequacy of internal controls over financial reporting, as well as confirmation by an external auditor. Section 302 requires management's quarterly certification of not only financial reporting controls but also disclosure controls and procedures.

Internal audit's roles in SOX-compliant organizations can range from advice regarding initial project design to project oversight, ongoing monitoring, and documentation and testing of key controls.

Example 1.2 Internal Auditing and the Japanese Kansayaku

Japanese corporate law prescribes the role of the *kansayaku*, or statutory auditor, for listed companies (*kabushiku gaisha*). Statutory auditors are appointed by the chief executive officer and board and endorsed by shareholders. Their role is to audit the directors' execution of their overall duties, including those related to accounting.

Some Japanese corporations will have both *kansayaku* and internal audit functions, although these are in the minority. However, in these cases, it is the responsibility of the *kansayaku*, rather than the internal auditors, to assess the performance of the board and chief executive officer.

Example 1.3 Internal Auditing in Portuguese-Listed Companies

Portugal operates similarly to the United States–based SOX regime. Its requirements for listed companies include the development of an internal control and risk management framework and an annual assessment of its effectiveness. In addition, companies are required to establish an audit committee or supervisory body and an internal audit function. However, unlike the United States, there are no criminal penalties for breaches of these requirements.

Similar to a number of other jurisdictions, regulations are stricter for the financial services industry. In this case, there is a requirement for separated internal audit and risk management activities.

Example 1.4 Public Sector Internal Auditing in the United Kingdom of Great Britain and Northern Ireland

The United Kingdom operates primarily (although not exclusively) as a three-tier government model, with a central government and often two tiers of local government. Some aspects of government are assigned to the Scottish and Welsh governments and Northern Ireland executives.

The UK government comprises ministerial and nonministerial departments and a large number of agencies and other public bodies. Departments are directed through Treasury guidance to establish an audit and risk assurance committee and an internal audit function operating to UK *Public Sector Internal Audit Standards*. The requirements for audit committees within agencies and other public bodies vary.

Local authorities—county, district, and borough councils—constitute the second and third tiers of government. There is no requirement in England for local authorities to have an audit committee, although guidance from the Chartered Institute of Public Finance and Accountancy (CIPFA) strongly recommends audit committees. Other parts of the United Kingdom have differing expectations regarding audit committees.

The *Public Sector Internal Audit Standards* came into effect in the United Kingdom on April 1, 2013, covering the whole of the public sector. The standards are based on the Institute of Internal Auditors' *International Standards, Definition of Internal Auditing,* and Code of Ethics.

Example 1.5 Internal Auditing in the Australian Government

There are three tiers of government within Australia: the federal/Commonwealth/Australian government, state/territory government (for each of the six states and two territories), and local government (for multiple municipalities or councils within each state or territory).

Commonwealth departments at the federal level operate under the *Financial Management and Accountability Act* (1997) and associated regulations, which require the following:

- Chief executives must establish and maintain an audit committee.
- Audit committees must have, wherever practicable, at least one external member.
- Audit committees must advise the chief executive about the internal audit plans of the entity.
- Audit committees must advise the chief executive about the standards used by internal audit.

State and local governments have different requirements for internal audits, depending on state legislation.

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Example 1.6 Internal Auditing in the Canadian Government

Similar to other Commonwealth countries such as Australia and the United Kingdom, Canada operates three tiers of government at the federal, provincial, and regional levels.

The *Federal Accountability Act* (2006) designated deputy ministers (chief executives) as accounting officers, accountable before the appropriate committee of Parliament, and required agencies to establish appropriate internal audit capacity and audit committees.

In addition to the Federal Accountability Act, the Treasury Board of Canada has developed a Policy on Internal Audit and Internal Auditing Standards for the Government of Canada based on the IIA's *Standards*.

The *Policy on Internal Audit* requires departments and agencies to:

- Establish an internal audit function that is appropriately resourced and that operates in accordance with the policy and professional internal auditing standards.
- Establish an independent departmental audit committee that includes a majority of external members who are not currently in the federal public service.
- Approve a departmental internal audit plan that addresses all areas of higher risk and significance and that is designed to support an annual opinion from the chief audit executive on departmental risk management, control, and governance processes.
- Ensure that management action plans are prepared that adequately address the recommendations and findings arising from internal audits, and that the action plans have been effectively implemented.
- Ensure that completed audit reports are issued in a timely manner and made accessible to the public with minimal formality.

Internal Audit Standards

The *International Standards for the Professional Practice of Internal Auditing* (*Standards*) produced by the IIA are the only set of internationally recognized standards for internal audit. Although a number of countries have developed their own internal audit standards, these are based in large part on the IIA's *Standards*.

International Professional Practices Framework

The *International Professional Practices Framework* (IPPF) is the IIA's authoritative guidance to the professional practice of internal auditing. It incorporates both mandatory and strongly recommended guidance.

The mandatory guidance consists of the definition of internal auditing, the *Standards*, and the Code of Ethics. The strongly recommended guidance comprises position papers, practice advisories, and practice guides.

INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING According to the IPPF (2013), the *Standards* are principle-focused and provide a framework for performing and promoting internal auditing. The *Standards* are mandatory requirements consisting of the following:

- Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance. The requirements are internationally applicable at the organizational and individual levels.
- Interpretations, which clarify terms or concepts within the statements.

The *Standards* are divided between Attribute and Performance standards. The *Attribute Standards* encompass the attributes of organizations and individuals undertaking internal auditing, whereas the *Performance Standards* describe the nature of internal auditing and quality criteria against which performance can be measured. Table 1.1 identifies the different series within the *Standards*.

Further detail regarding the *Standards* is provided in Appendix A.

TABLE 1.1 IIA Standards

Standard Series	Standard Number
Attribute Standards	
Purpose, Authority, and Responsibility	1000
Independence and Objectivity	1100
Proficiency and Due Professional Care	1200
Quality Assurance and Improvement Program	1300
Performance Standards	
Managing the Internal Audit Activity	2000
Nature of Work	2100
Engagement Planning	2200
Performing the Engagement	2300
Communicating Results	2400
Monitoring Progress	2500
Communicating the Acceptance of Risks	2600

Source: IIA (2013).

CODE OF ETHICS The IIA (2013) identifies the purpose of its Code of Ethics as being to *promote an ethical culture in the profession of internal* auditing. The Code of Ethics incorporates the principles that internal auditors are expected to apply and uphold and the rules of conduct for internal auditing.

The principles and rules of conduct are subdivided into four categories: integrity, objectivity, confidentiality, and competency.

Integrity

Internal auditors:

- Shall perform their work with honesty, diligence, and responsibility.
- Shall observe the law and make disclosures expected by the law and the profession.
- 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.
- Shall respect and contribute to the legitimate and ethical objectives of the organization.

Objectivity

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.
- Shall not accept anything that may impair or be presumed to impair their professional judgment.
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

Confidentiality

Internal auditors:

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

Competency

Internal auditors:

- Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- Shall perform internal audit services in accordance with the *International Standards for the Professional Practice of Internal Auditing*.
- Shall continuously improve their proficiency and the effectiveness and quality of their services.

The Need for Standards

Standards establish a professional framework for undertaking internal audit engagements. They provide assurance that internal auditors operate in a responsible, ethical manner using commonly accepted practices. Applying standards assures management, as well as other key stakeholders like the audit committee, that the internal audit function is operating in a professional manner.

Using standards automatically builds excellence into internal audit engagements and results in quality practices being embedded within daily activities. Perhaps even more important, conforming with recognized standards sets an example for the organization that internal audit is operating in accordance with professional norms and sets a benchmark for the rest of the organization.

Some internal auditors are mandated to use standards. Usually, this is due to (1) professional membership requirements, (2) legal or regulatory requirements, or (3) procurement and contractual requirements. As an IIA member, individuals are required to conform with those standards identified as being applicable to individuals. However, chief audit executives who are members of the IIA are obligated to conform with all of the IIA *Standards*.

Why Use the IIA's *Standards*?

The IIA's *Standards* are the only set of internationally recognized standards specific to internal auditing. The IIA *Standards* are principles based and designed to guide the way internal auditors operate. Being principles based, the *Standards* are neither prescriptive nor inappropriately restrictive. They do not prevent internal auditors from being creative or innovative but provide criteria for internal auditors to operate against. They establish a framework that allows internal auditors to benchmark themselves against other professionals and can guide internal auditors in the way they perform their work.

Conclusion

The establishment of the Institute of Internal Auditors has been a major contributor to the professionalization of internal auditing. Through the application of a set of internationally recognized standards, internal auditors can demonstrate their professionalism and provide assurance to management and the audit committee that they are operating in an ethical, transparent, and impartial manner.

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