

PART ONE

# Foundations of Modern Internal Auditing

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# Significance of Internal Auditing in Enterprises Today: An Update

THE PROFESSION OF AUDITING HAS been with us for a long time. Mesopotamian scribes in around 3000 BC utilized elaborate systems of internal controls using stone documents that contained ticks, dots, and checkmarks. Auditing has evolved over the millennia, and today we generally think of two basic types of business enterprise auditors: external and internal. An external auditor is chartered by a regulatory authority, with authority to visit an enterprise or entity to independently review and report on the results of that review. Those reviews generally cover financial statements but may involve other compliance areas. In the United States, financial external auditors are Certified Public Accountants (CPAs), who are state-licensed and follow the standards of the American Institute of Certified Public Accountants (AICPA; [www.aicpa.org](http://www.aicpa.org)). However, there are many other types of external auditors in fields such as medical equipment devices, television viewer ratings, and multiple governmental areas.

Internal auditing, as discussed throughout this book, 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, information technology systems controls, or manufacturing quality processes. Most internal auditors follow high-level standards established by their prime professional enterprise, the Institute of Internal Auditors (IIA; [www.theiia.org](http://www.theiia.org)), but there are many different practices and approaches to internal auditing today due to its worldwide nature and wide range of auditing activities.

The primary objective of this book is to define and describe internal auditing as it is or should be performed today—modern internal auditing—as well as to describe a *common body of knowledge (CBOK)* for internal auditing. Because of modern internal auditing's many variations and nuances, the chapters following describe and discuss it in terms of this CBOK, the key tools and knowledge areas that all internal auditors should generally use in their internal audit activities or at least know, as well as some

other knowledge areas where internal auditors should have at least a good general understanding. These are the common practices that are essential to the profession of modern internal auditing.

An effective way to begin to understand internal auditing and its key CBOK areas is to refer to the internationally recognized internal audit professional organization, the IIA, and its published professional standards that define the practice:

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, in contrast to external auditors, outside public accountants, or other parties such as government regulators who are not directly a part of the particular enterprise.

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

- *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.
- *Appraisal* confirms the need for an evaluation that is the thrust of internal auditors as they develop their conclusions.
- *Established* confirms that internal audit is a formal, definitive function in the modern enterprise.
- *Examine and evaluate* describe the active roles of internal auditors, first for fact-finding inquiries and then for judgmental evaluations.
- *Its activities* confirm the broad jurisdictional scope of internal audit work that applies to all of the processes and activities of the modern enterprise.
- *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.
- *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 stakeholders.

As a small terminology point, the chapters following will generally use the term *enterprise* to refer to the whole company or business, and the term *organization* or *function* to reference 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 internal auditing and internal audit professionals.

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 then proceeds to implement its plans in terms of operations, it must do something to monitor the operations to assure the achievement of its established objectives. These further efforts can be thought of as *controls*. While the internal audit function is itself one of the types of controls used, there is a wide range of other organization- or 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 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 overall enterprise. Internal auditors cannot be expected to equal, let alone exceed, the technical and operational expertise pertaining to the many various activities of an enterprise. However, they can help the responsible individuals achieve more effective results by appraising existing controls and providing a basis for helping to improve them. In addition, because internal auditors often have a good knowledge and understanding of many organizational units or special activities within a total enterprise, their levels of understanding often exceed those of other people.

## 1.1 INTERNAL AUDITING HISTORY AND BACKGROUND

The need for effective control processes created the concept of internal auditing. Despite its ancient roots, however, 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 as well as the rest of the world had just gone through a major economic depression. As a legislative corrective action, the SEC required that all enterprises registered with it must provide financial statements certified by independent auditors. This requirement also prompted corporations to establish internal auditing departments, but with the objective primarily to assist their independent auditors. At that time, external financial auditors were focused 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.

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.”<sup>1</sup> Those 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 1970s, 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 internal auditing just before going 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 *Modern Internal Auditing*.

About that same time, in 1942, the IIA was launched. Its first 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 wanted to both share their experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over the years and has resulted in the multifaceted profession of the modern internal auditor discussed in this book.

The typical business enterprise of the 1940s, when modern internal auditing was just getting started, required a very different skill set than 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 these machines started to become useful for record-keeping and other computational and accounting functions. Similarly, enterprises had very rudimentary telephone connections where 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 often wireless telecommunications and the Internet. The increasing complexity of modern business and other enterprises has created the need for internal auditors to become ever-greater 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 those 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 himself or herself how well a particular task has been accomplished, and perhaps how it might be done better. 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, he or she will find it increasingly difficult to know whether the interests of the enterprise are being properly served as the enterprise grows larger and more complex. 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 ultimate response to these questions is that the manager must obtain further help by assigning one or more individuals to be directly responsible for reviewing activities and reporting on the previously mentioned types of questions. It is here that the internal auditing activity comes into being in a formal and explicit sense. The first internal auditing assignments usually originated to satisfy very basic and sharply defined operational needs. The earliest special concern 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 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 were 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 once had major responsibilities for reconciling canceled payroll checks with bank statements or checking the mathematics in regular business documents. As mentioned, internal auditors in smaller retail enterprises are often still responsible for reconciling daily cash sales to recorded sales receipts.

Understanding the *history of internal auditing* is important because this old image of internal auditors still exists to some extent in various places in the world. This is so even though the character of the internal auditing function is now very different. Over 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 there seemed to be every good reason for getting greater value from them with relatively little increase in cost.

Internal auditors perceived these opportunities and initiated new types of services themselves. Thus they gradually took on broader and more management-oriented responsibilities in their work efforts. Because internal auditing was initially largely accounting-oriented, this upward 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 now usually questioned 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, such as the COSO (Committee of Sponsoring Organizations) internal control framework discussed in Chapters 3 and 4 or the Sarbanes-Oxley Act (SOx) requirements, highlighted in Chapter 5, have caused a continuing increase in the need for the services of internal auditors. In addition, internal auditors today should be very much interested in governance, risk, and compliance (GRC) issues that are emphasized in our chapters on COSO internal controls and discussed in other chapters.

Internal auditors in past years often felt that fraud detection and prevention were not their responsibility but were an issue for legal authorities. Similarly, risk management in the past was often viewed as a concern only for the insurance department and not internal audit. But the profession has changed, and an understanding of both of these issues should be part of an internal auditors' common body of knowledge; risk management is discussed in Chapter 7, and fraud detection and prevention in Chapter 27.

Ethics and social responsibility issues are another concern for the modern internal auditor and are discussed in Chapter 26. As a result of these new pressures, the skills and 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 New York City, 25-member charter chapter in 1942 to an international association with about 150,000 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 9. 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. Today, internal audit's role is constantly being redefined. Internal auditing has moved beyond being a staff activity often roughly tied to the controller's department, to a function reporting to the audit committee of the board, and SOx, discussed in Chapter 5, has been a major driver of change for internal auditors in the United States and worldwide. While they once had a nominal reporting relationship to the audit committee of the board, 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, it still suffers from being integrated too closely with regular accounting activities and limits virtually all of its audit work to strictly financial areas. These are all exceptions that do not reflect the potential capabilities of modern internal auditors. They may also reflect a lack of progressive attitudes in the overall enterprise.

Today, internal audit has expanded its activities to all operational areas of the modern enterprise and has established itself as a valued and respected part of the senior management resources. The modern internal auditor is formally and actively serving the board of directors' audit committee, and the person responsible for an internal audit function, the chief audit executive, today has direct and active communication with the 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 MISSION OF INTERNAL AUDITING

Management authors over the years have talked about the need for and importance of enterprises and organizations at all levels to establish formal *mission statements* to help management and all members of the enterprise team set consistent goals in their activities. Formal mission statements are an important and now well-recognized concept. This author in past editions of this book has talked about the importance of mission statements and how internal auditors should look for them when reviewing enterprise operations.

However, many internal audit professionals and certainly this author did not give sufficient attention to the fact that internal auditors lacked their own mission statement. Perhaps the definition of internal auditing and internal auditors' long history of reviewing internal controls and assisting management with its recommendations caused internal auditors themselves to assume that their mission is understood by all.

The internal auditors' professional organization, the IIA, has now decided that all internal auditors need to have a mission statement that supports the profession. The IIA ties internal audit standards and other important internal auditing attributes into what is called the *International Professional Practices Framework (IPPF)*, an effort to bring standards and other internal audit attributes together. The mission of internal auditing is:

To enhance and protect organizational value by providing stakeholders with risk-based objective and reliable assurance, advice and insight.

These are valuable concepts to help understand the role and importance of internal auditing that we will reference in the chapters going forward. The purpose of this internal auditing mission statement is to provide internal auditors with a clear understanding of what they should aspire to achieve in their enterprises. Along with the definition of internal auditing introduced in this chapter, internal audit standards from Chapter 9, and other materials in the following chapters, this mission statement should help them better understand their roles. An understating of this internal audit mission statement is a strong internal audit CBOK requirement.

## 1.3 ORGANIZATION OF THIS BOOK

The 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 (CBOK) for the profession. While we generally think of an internal auditor as a professional affiliated with the IIA and its standards, he or she is really a larger, broader person today. Many enterprises have a parallel—almost a shadow—group of quality auditors who primarily follow the internal audit standards of the American Society for Quality (ASQ; [www.asq.org](http://www.asq.org)). These are internal auditors with different backgrounds but similar approaches to IIA-background internal auditors; we should hopefully see greater convergence of these two in the years ahead.

This book's 34 chapters endeavor 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 are organized into eight parts or sections as discussed in Chapter 2.

The chapters following define a professional CBOK for internal auditors, the areas that all internal auditors should know and understand. When Victor Brink developed this first edition many years ago, he was defining a modern internal auditor as a new and important professional who was more than just an external auditor's helper. How the profession has grown and changed! Our modern internal auditing CBOK emphasizes the roles and responsibilities of today's modern internal auditor. It is our objective that the materials in the following chapters will help all internal auditors to gain knowledge and expertise in this 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.

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