CHAPTER ONE

Foundations of Internal Auditing

1.1 WHAT IS INTERNAL AUDITING?

An effective way to begin this book about modern internal auditing is to refer to the professional standards of the Institute of Internal Auditors (IIA). This internal auditor professional organization defines the practice of internal auditing as follows: *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 or other business records, or more broadly, as a thoughtful review and appraisal at the highest organizational level. In this book, we use the term *auditing* to include this total range of levels of service, from detailed checking of accounting balances to higher-level operational appraisals.

The term *internal* defines work carried on within the organization by its own employees. Internal auditing work is distinguished from such audit-related work carried on by outside public accountants or other parties (such as government regulators) who are not directly a part of an organization.

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

- *Independent* means auditing that is free of restrictions that could significantly limit the scope and effectiveness of the 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 organization.
- *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 activities of the modern organization.
- *Service* reveals that help and assistance to management and other members of the organization are the end products of all internal auditing work.
- *To the organization* confirms that internal audit's total service scope pertains to the entire organization, including all personnel, the board of directors and its audit committee, stockholders, and other interested stakeholders.

Internal auditing can also be recognized as an organizational control that functions by measuring and evaluating the effectiveness of other controls. When an organization establishes its planning and then proceeds to implement its plans in terms of operations, it must do something to monitor the operations to ensure 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 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 organization.

Internal auditors who do their job effectively become experts in what makes for the best possible design and implementation of all types of controls. 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 control door that internal auditors come to examine and evaluate all organizational activities to provide maximum service to the organization. Internal auditors cannot be expected to equal—let alone exceed—the technical and operational expertise pertaining to the many activities of the organization. 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.

1.2 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. The business organization of 1942, when modern internal auditing was just getting started, was very different from our twenty-first century organization of today. For example, aside from some electromechanical devices and activities in research laboratories, computer systems did not exist. Organizations had no need for computer programmers until these machines started to become useful for various record keeping and other computational functions. Similarly, organizations 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 telecommunications and the Internet. The increasing complexity of modern business and other organizations has created the need for a similar specialist in various business controls: the internal auditor. We can 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 the 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 organization become more voluminous and complex, it is no longer practicable for the owner or top manager to have enough contact with every aspect of operations to satisfactorily review their effectiveness. These operations review responsibilities need to be delegated.

Although this hypothetical senior manager could build a supervisory system to try to provide a personal overview of operations, that same manager will find it increasingly difficult to know whether all of the interests of the organization are being properly served as it 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 organization 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 was initially viewed as a closely related extension of the work of external auditors.

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

Understanding the history of internal auditing is important because this old image still persists, to some extent, for today's modern internal auditors. This is so even though the character of the internal auditing function is now very different.

Over time, the operations of various organizations increased in volume and complexity, creating managerial problems and new pressures on senior management. In response to these pressures, management recognized the possibilities for better utilization of their internal auditors. Here were individuals already set up in an audit function, and there seemed to be every good reason for getting greater value from these individuals with relatively little increase in cost.

At the same time, internal auditors perceived 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 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 documentation lacking a supervisor's initials—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 organization.

In 1942, the Institute of Internal Auditors (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 internal auditor by their organizations and who wanted to both share experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over subsequent years and has resulted in the type of modern internal auditor discussed in this book.

New business initiatives, such as the COSO (Committee of Sponsoring Organizations) internal control framework discussed in Chapter 4, "Internal Controls Fundamentals: COSO Framework," or the Sarbanes-Oxley Act (SOA) discussed in Chapter 3, "Internal Audit in the Twenty-First Century: Sarbanes-Oxley and Beyond," and Chapter 6, "Evaluating Internal Controls: Section 404 Assessments," 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 a changed role for the outside public accountant.

Ethics, whistleblower programs, and codes of conduct issues will be discussed in Chapter 9, "Whistleblower Programs and Codes of Conduct." As a result of these new business directions, the services of internal auditors have become more important to a wide range of interested parties in the organization. There are now more and better-qualified internal auditing personnel and a higher level of organizational status and importance attached to them. 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 many professionals through their Standards for the Professional Practice of Internal Auditing, as will be discussed in Chapter 12, "Internal Audit Professional Standards." 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 and financial activity and levels of coverage. In organizations today, internal auditing has moved beyond being a staff activity roughly tied to the controller's organization, although internal audit's role is constantly being redefined. SOA has been a major driver of change for internal auditors. While they once only had a nominal reporting relationship to the audit committee of the board, SOA has strengthened and formalized that reporting relationship. However, in some other organizations, internal audit continues to function at just a routine compliance level. In other situations, internal audit 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 the modern internal audit organization. They may also reflect the lack of progressive attitudes in the overall organization.

Today, modern internal auditors have expanded their activities to all operational areas of the organization and have established themselves as valued and respected parts of the senior management effort. With renewed emphasis from SOA, the modern internal auditor today is formally and actively serving the board of director's audit committee. While internal audit organizations once had an almost nonexistent, dotted line reporting relationship to their audit committee—with little direct communication—the chief audit executive (CAE) today has direct and active level of communication with that same audit committee. This overall situation reflects major progress in the scope of internal audit's coverage and level of service to all areas of the organization. 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. Internal audit's service responsibilities to the audit committee will be discussed in Chapter 8, "Internal Audit and the Board Audit Committee."

1.3 RELATIONSHIPS OF OPERATIONAL, FINANCIAL, AND INFORMATION SYSTEMS AUDITING

During the 1960s, there was a strong tendency for many to use the term of *operational auditing* in place of the traditional *internal auditing*. The rationale was that *internal auditing* was a term tied too closely with basic financial auditing, including the external auditor's review of both financial control activities and financial statements. Internal auditors called themselves operational auditors because of their desire to focus more of their efforts on the other operational activities in the organization that could potentially point to areas for increased profit and overall management service. In its most extreme form, the so-called operational auditing function would disassociate itself entirely from the so-called financial areas. They would claim, for example, to have no expertise on the financial controls surrounding an accounts receivable operation. Rather, they might look at process controls and ignore the issue of whether the cash received was properly recorded and tied to financial accounts, including the general ledger. Management often became confused and dismayed when their internal auditors all but ignored these important accounting or financial-related issues. This separation of responsibility created issues of both substance and self-interest for the *operational audit*–oriented internal auditors.

Traditionally, internal auditors had been concerned with both accounting and financial processes, and some expertise in these areas had generally been considered to be essential. Coverage of accounting and financial controls and processes also provided an opportunity for expanding the range of internal audit services into the broader operational areas. Since accounting and financial records directly or indirectly reflect all operational activities, financially oriented internal audit reviews often open doors to the other activities. This combination of operational and financial internal audit practices as well as information systems auditing will be considered throughout this book. In terms of strategy, an internal audit abandonment of accounting and financial areas can create a vacuum that would invite the emergence of other audit-type functions. Chapter 26, "Internal Audit Quality Assurance and ASQ Quality Audits" for example, will discuss how many traditional internal auditors in the past ignored the International Organization for Standardization (ISO) "quality" movement in its early days, leading to an almost separate profession of quality auditors.

An internal audit function today needs to have an adequate coverage of key accounting and financial areas, and the responsibilities of whomever does that will inevitably spill over into an overview of broader operational areas. The failure to cover key financial areas was one of the arguments external audit firms made to senior management when they offered to provide internal audit outsourcing services. For some years leading up to the enactment of SOA, it almost appeared that the public accounting firms were taking over internal auditing through their outsourcing arrangements. Now, an organization's external auditors are prohibited from also performing internal audits for the same organization. These new SOA-mandated rules will be discussed in Chapter 3.

In the wake of SOA and the internal control assessment requirements of the Act's Section 404 requirements (discussed in Chapter 6) internal audits' roles and responsibilities are changing again as we move through the first decade of the twenty-first century. Internal auditors today are a much more important element in an organization's overall internal control framework than they were not that many years in the past. To be effective here, an internal auditor must gain a strong understanding of internal controls, and any internal audit involvement with SOA Section 404 reviews require some understanding of generally accepted accounting principles (GAAP) and their related financial controls. Therefore, internal auditors today need to understand financial and operational as well as information systems controls. An objective of this book is to cover all three of these areas, but to cover them in a manner whereby they are not considered separate internal audit practices, but represent skills and knowledge that should be used by all internal auditors.