Chapter 1

INTRODUCTION

Introduction

The second edition of the *Internal Auditing Handbook* was published in December 2003 and reflected the significant changes in the field of internal auditing over the last few years. This detailed handbook comprised over 700 pages of text covering all aspects of the work of the 'new look' internal auditors who carry the weight of a heightened expectation from society on their shoulders. *The Essential Handbook of Internal Auditing* is a slimmed down version of the original handbook and is aimed at students, auditors, managers and the growing army of people who need to know a little more about internal auditing. In this way, *The Essential Handbook* consists of extracts from the main handbook for those who need a less detailed account of the world and work of the internal auditor. Note that the term chief audit executive (CAE) is used throughout the handbook to describe the top position within an organization responsible for the internal audit activities.

1.1 Reasoning behind the Book

The new context for internal auditing is set firmly within the corporate governance arena. As a response, the Institute of Internal Auditors has designed a new definition 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 organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.[1]

The Essential Handbook of Internal Auditing contains the same format as the original handbook and includes chapters on Corporate Governance Perspectives, Managing Risk and Internal Controls. It is only after having addressed these three interrelated topics that we can really appreciate the internal audit role. There are chapters on professional standards, audit approaches, managing internal audit, planning, performing and reporting audit work and specialist areas such as consulting projects, fraud and information systems. The final chapter attempts to look towards the future. Note that there are several updates in this new book whenever it has been necessary to track important developments during 2004 and beyond.

1.2 The IIA Standards and Links to the Book

The Essential Handbook addresses many aspects of internal auditing that are documented in the Institute of Internal Auditors' (IIA) professional standards. The Attribute Standards outline what a good internal audit set-up should look like, while the Performance Standards set a benchmark for the audit task. Together with the Practice Advisories (and Professional Briefing Notes) and other reference material they constitute a professional framework for internal auditing.

1.3 How to Navigate around the Book

A brief synopsis of the Handbook should help the reader work through the material.

Chapter 1 — Introduction

This first chapter deals with the content of the Handbook. It is important to establish the role of internal audit at the start of the book to retain this focus throughout the next few chapters that cover corporate perspectives.

Chapter 2 — Corporate Governance Perspectives

Chapter 2 covers corporate governance in general in that it summarizes the topic from a business standpoint rather than focusing just on the internal audit provisions. The governance equation is quickly established, and then profiles of some of the well-known scandals are used to demonstrate how fragile the accountability frameworks are. New look models of corporate governance are detailed using extracts from various codes and guidance to form a challenge to business, government and not-for-profit sectors.

Chapter 3 — Managing Risk

Many writers argue that we are entering a new dimension of business, accounting and audit whereby risk-based strategies are essential to the continuing success of all organizations. Reference is made to various risk standards and policies and we comment on the need to formulate a risk management cycle as part of the response to threats and opportunities.

Chapter 4 — Internal Controls

Some noted writers argue that internal control is a most important concept for internal auditors to get to grips with. Others simply suggest that we need to understand where controls fit into the risk management equation. Whatever the case, it is important to address this topic before we can get into the detailed material on internal auditing.

Chapter 5 — The Internal Audit Role

This chapter moves into the front line of internal audit material. Having got through the reasoning behind the audit role (governance, risk management and control), we can turn to the actual role. The basic building blocks of the charter, independence, ethics and so on are all essential aspects of the Handbook.

Chapter 6 — Professionalism

The auditors' work will be determined by the needs of the organization and the experiences of senior auditors, and most audit shops arrive at a workable compromise. One feature of

the upwards direction of the internal audit function is the growing importance of professional standards and this is dealt with in Chapter six.

Chapter 7—The Audit Approach

There is a wide range and variety of audit services that fall under the guise of internal auditing and a lot depends on the adopted approach. Rather than simply fall into one approach, it is much better to assess the available positions armed with a good knowledge of possible alternatives. Control Risk Self-Assessment (CRSA) is discussed along with other specialist audit work involving management consulting, fraud investigations and information systems auditing.

Chapter 8—Setting an Audit Strategy

One view is that formulating an internal audit strategy is one of the most important tasks for the chief audit executives and this is covered in Chapter eight.

Chapter 9—Audit Field Work

Audit field work covers the entire audit process, from planning the assignment to reporting the results, while interviewing is discussed as an important means of obtaining information for the audit.

Chapter 10—Meeting the Challenge

This short chapter attempts to track key developments that impact on internal auditing and includes comments from various sources on its future direction.

1.4 The Handbook as a Development Tool

The Essential Handbook of Internal Auditing contains a basic foundation of audit information that should be assimilated by the reader and there are various multi-choice questions at the end of each chapter that can be used to gauge the extent to which this assimilation is working (see Appendix A for a suggested answer guide). Answers to the multi-choice questions may be entered in the form that can be found at Appendix B. Where *The Essential Handbook* is being used as an educational tool by universities and colleges, the answer guide should be removed before the book is given out to students. Students may be given three minutes per question to tackle the multi-choice questions and asked to record their answers as Appendix B. There are some 100 questions and a score of 60% and above may suggest that the student or audit trainee has achieved an acceptable standard in acquiring a basic understanding of modern internal auditing.

1.5 The Development of Internal Auditing

Internal audit is now a fully developed profession. An individual employed in internal audit ten years ago would find an unrecognizable situation in terms of the audit role, services provided, and

approach. For a full appreciation of internal auditing, it is necessary to trace these developments and extend trends into the future. It is a good idea to start with the late Lawrence Sawyer, known as the Godfather of internal audit, to open the debate on the audit role. Sawyer has said that audit has a long and noble history: 'Ancient Rome "hearing of accounts" one official compares records with another—oral verification gave rise to the term "audit" from the Latin "auditus"—a hearing.'[2]

The Evolution of the Audit Function

It is important to understand the roots of internal auditing and the way it has developed over the years.

1 Extension of external audit   Internal audit developed as an extension of the external audit role in testing the reliability of accounting records that contribute to published financial statements. The IIA.UK&Ireland have suggested this link between external and internal audit:

> The nineteenth century saw the proliferation of owners who delegated the day-to-day management of their businesses to others. These owners needed an independent assessment of the performance of their organizations. They were at greater risk of error, omissions or fraud in the business activities and in the reporting of the performance of these businesses than owner-managers. This first gave rise to the profession of external auditing. External auditors examine the accounting data and give owners an opinion on the accuracy and reliability of this data. More slowly the need for internal auditing of business activities was recognized. Initially this activity focused on the accounting records. Gradually it has evolved as an assurance and consulting activity focused on risk management, control and governance processes. Both external audit and internal audit exist because owners cannot directly satisfy themselves on the performance and reporting of their business and their managers cannot give an independent view.[3]

2 Internal check   The testing role progressed to cover non-financial areas, and this equated the internal audit function to a form of internal check. Vast numbers of transactions were double-checked to provide assurances that they were correct and properly authorized by laid-down procedures. The infamous 'audit stamp' reigned supreme indicating that a document was deemed correct and above board.

3 Probity work   Probity work arrived next as an adaptation of checking accounting records where the auditors would arrive unannounced at various locations and local offices, and perform a detailed series of tests according to a preconceived audit programme. Management was presented with a list of errors and queries that were uncovered by the auditors. The auditors either worked as a small team based in accountancy or had dual posts where they had special audit duties in addition to their general accounting role.

4 Non-financial systems   The shift in low-level checking arose when audit acquired a degree of separation from the accounting function with internal audit sections being purposely established. This allowed a level of audit management to develop which in turn raised the status of the audit function away from a complement of junior staff completing standardized audit programmes.

5 Chief auditors   Another thrust towards a high profile, professional audit department was provided through employing chief internal auditors (or chief audit executives) with high organizational status.

6 Audit committees   Audit committees bring about the concept of the audit function reporting to the highest levels and this had a positive impact on perceived status. Securing the attention of the board, chief executive, managing director, non-executive directors and senior management also provides an avenue for high-level audit work, able to tackle the most sensitive corporate issues.

7 Professionalism   The Institute of Internal Auditors (IIA) has some history going back over 50 years. *Brink's Modern Internal Auditing* has outlined the development of the IIA:

> In 1942, IIA was launched. Its first membership was started in New York City, with Chicago soon to follow. The IIA was formed by people who were given the title internal auditor by their organizations and 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.[4]

The Development of Internal Audit Services

The developmental process outlined above highlights the way the function has progressed in assuming a higher profile and a greater degree of professionalism, and these developments over the last 20 years may likewise be traced:

1 Internal check procedures   Internal audit was seen as an integral component of the internal checking procedures designed to double-check accounting transactions.

2 Transaction-based approach   The transactions approach came next, where a continuous programme of tests was used to isolate errors or frauds.

3 Statistical sampling   Statistical sampling was later applied to reduce the level of testing along with a move away from examining all available documents or book entries.

4 Probity-based work   Probity-based work developed next, again featuring the transaction approach where anything untoward was investigated.

5 Spot checks   It was then possible to reduce the level of probity visits by making unannounced spot checks so that the audit deterrent (the possibility of being audited) would reduce the risk of irregularity. Moreover, most internal auditors assumed a 'Gotha' mentality where their greatest achievements resided in the task of finding errors, abuse and/or neglect by managers and their staff.

6 Risk analysis   The transaction/probity approach could be restricted by applying a form of risk analysis to the defined audit areas so that only high risk ones would be visited. Each unit might then be ranked so that the high risk ones would be visited first and/or using greater resources.

7 Systems-based approach   Then came a move away from the regime of management by fear to a more helpful service. Systems-based audits (SBA) are used to advise management on the types of controls they should be using. Testing was directed more at the controls than to highlight errors for their own sake.

8 Operational audit   Attention to operational areas outside the financial arena provided an opportunity to perform work not done by the external auditor. The concepts of economy,

efficiency and effectiveness were built into models that evaluated the value-for-money implications of an area under review.

9 Management audit   Management audit moves up a level to address control issues arising from managing an activity. It involves an appreciation of the finer points relating to the various managerial processes that move the organization towards its objectives.

10 Risk-based auditing   Many internal audit shops have now moved into risk-based auditing where the audit service is driven by the way the organization perceives and manages risk. Rather than start with set controls and whether they are being applied throughout the organization properly, the audit process starts with understanding the risks that need to be addressed by these systems of internal control.

This is no linear progression in audit services with many forces working to take the profession back to more traditional models of the audit role where compliance and fraud work (financial propriety) are the key services in demand.

Moving Internal Audit out of Accountancy

Many of the trends behind the development of internal audit point to the ultimate position where the audit function becomes a high profile autonomous department reporting at the highest level. This may depend on moving out audit functions currently based in accountancy. It is possible to establish internal audit as a separate profession so that one would employ internal auditors as opposed to accountants. This is a moot point in that there are those who feel that the auditor is above all an accountant. Not only is this view short-sighted but it is also steeped in the old version of the internal auditor as a poor cousin of the external auditor. The true audit professional is called upon to review complicated and varied systems even if the more complicated and sensitive ones may often be financially based. A multidisciplinary approach provides the flexibility required to deal with operational areas. Many organizations require internal auditors to hold an accounting qualification or have accountancy experience. A move outside the finance function allows staff to be employed without an accounting background. There are clear benefits in this move in terms of securing a firmer level of independence from the finance function:

- The traditional reporting line to the director of finance (DF) may have in the past created a potential barrier to audit objectivity.
- One might therefore give greater attention to the managerial aspects of providing financial systems and move away from merely checking the resulting transactions.
- The relationship with external audit may become better defined where the differing objectives are clarified.
- The audit approach may move from an emphasis on financial audits to the exciting prospect of reviewing the entire risk management process itself.
- The potential for establishing a powerful chief audit executive (CAE) may arise which might be compared to the previous position where the CAE merely acted as a go-between for the director of finance (DF) and the audit staff, giving them batches of projects that the DF wanted done.

In short we would need to be close to, but at the same time be some distance from, the DF. However, as we move into the era of the audit committee, and the stronger links between this forum and internal audit, things are changing. The trend is for more of a break between the

finance link, as internal audit gets more and more involved in the actual business side of the organization. Again, this move is strengthened by the growing involvement in enterprise-wide risk management. The latest position is that there is normally no longer a clear logic to the chief audit executive to continue to hold a reporting line to the director of finance.

Influences on the Internal Audit Role

1 Contracting out internal audit All internal auditing departments are under threat where the in-house unit may be deleted, downsized or replaced by an inspectorate, quality assurance or operational review service. All CAEs should have a number of key issues uppermost in their minds including:

- A formal strategy for meeting competition from internal and/or external sources.
- The audit budget and current charge-out rates for each auditor and how these figures compare to other audit departments.
- The pricing strategy for audit services will range between being cheap and cheerful to being extremely expensive.

The pricing strategy cannot be completed until marketing research has been carried out that establishes exactly what the client requires.

2 Globalization The big picture of internal auditing must include that it is a discipline universally applicable throughout the world. The IIA's professional standards are applied in each member country with slight changes in terminology to accommodate local requirements, and there now exists a Global IIA with relevant representation from across the world.

3 Quality management The continuing interest in quality management is derived from a desire to secure excellence in service/product delivery. This allows a top downwards review of existing practices. Internal auditors are well versed in the principles and practice of management, which is examined in IIA examinations.

4 The compliance role There is some debate on the role of internal audit in compliance with procedure. The technical view argues we have moved away from detailed checking as the profession developed. One may now audit corporate systems of importance to the entire welfare of the organization. However, there are organizations such as banks and retail companies that make great play of compliance checks and have a need for an audit service that management knows and understands.

5 Independence Much has been written on independence and it is no longer treated as an esoteric entity that is either held on to, or given up through greed or ignorance. A response to the threat of external competition from the big accountancy firms was that they could not be independent. This argument is insufficient. Independence is perceived more practically as the basic ability to do a good job.

6 The expectation gap Audit services will have to be properly marketed, which is essentially based on defining and meeting client needs. This feature poses no problem as long as clients know what to expect from their internal auditors. It does, however, become a concern when this is not the case, and there is a clear gap in what is expected and what is provided.

7 *Legislation* This is an important component in the development of internal auditing:

- It may alter the audit role by providing additional work.
- It may bring into the frame competitors for the current audit contract.
- It may impact the status of internal auditing, e.g. any moves towards mandatory audit committees or for that matter mandatory internal audit.

8 *Corporate governance, risk management and control* As suggested by the new definition of internal auditing, these three concepts now form the framework for the design and provision of the internal audit service. This is why the next three chapters deal with these topics.

Summary and Conclusions

This first chapter of *The Essential Handbook* takes the reader through the structure of the book and highlights the pivotal role of the IIA standards. We have also provided a brief snapshot of the development of the internal audit role as an introduction to the subject. Many of the points mentioned above are dealt with in some detail in the main part of the book, although it is as well to keep in mind the basics of internal audit while reading more widely. The concept of internal audit is really quite simple—it is the task of putting the ideals into practice that proves more trying. We have featured Sawyer's views in this chapter, which is why we close with another quote on the wide range of benefits from a good internal audit team:

IA can assist top management in:

- monitoring activities top management cannot itself monitor;
- identifying and minimizing risks;
- validating reports to senior management;
- protecting senior management in technical analysis beyond its ken;
- providing information for the decision-making process;
- reviewing for the future as well as for the past;
- helping line managers manage by pointing to violation of procedures and management principles.[5]

Whatever the new risk-centred jargon used to describe the audit role, many of the above benefits described by Sawyer remain constant. A worthwhile profession is based on clear principles, and not just fancy jargon.

Chapter 1: Multi-Choice Questions

Having worked through the chapter the following multi-choice questions may be attempted. (See Appendix A for suggested answer guide and Appendix B where you may record your score).

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

    a. professional.
    b. objective.
    c. systematic.
    d. reliable.

2. Which is the most appropriate sentence?
    a. The Implementation Standards outline what a good internal audit set-up should look like, while the Performance Standards set a benchmark for the audit task.
    b. The Attribute Standards outline what a good internal audit set-up should look like, while the Performance Standards set a benchmark for the audit structure.
    c. The Attribute Standards outline what a good internal audit set-up should look like, while the Performance Standards set a benchmark for the audit task.
    d. The Attribute Standards outline what a good internal audit set-up should do, while the Performance Standards set a benchmark for the audit task.

3. Insert the missing word:
Sawyer has said that audit has a long and noble history: 'Ancient Rome "hearing of accounts" one official compares records with another—oral verification gave rise to the term "audit" from the Latin "auditus"— . . . . '.
    a. conference.
    b. verification.
    c. account.
    d. hearing.

4. Insert the missing word:
The infamous . . . . reigned supreme indicating that a document was deemed correct and above board.
    a. 'audit stamp'.
    b. 'audit approval'.
    c. 'audit nose'.
    d. 'sign-off'.

5. Which is the most appropriate sentence?
    a. Moreover, most internal auditors assumed a 'Gotha' mentality where their greatest achievements resided in the task of finding good performance by managers and their staff.
    b. Moreover, most internal auditors assumed a 'Gotha' mentality where their greatest fear resided in the task of finding errors, abuse and/or neglect by managers and their staff.
    c. Moreover, most internal auditors assumed a 'Gotha' mentality where their greatest achievements resided in the task of finding errors, abuse and/or neglect by managers and their staff.
    d. Moreover, most internal auditors assumed a 'partnership' mentality where their greatest achievements resided in the task of finding errors, abuse and/or neglect by managers and their staff.

References

1. IIA Professional Practices Framework.
2. Sawyer, Lawrence B. and Dittenhofer, Mortimer A., Assisted by Scheiner James H. (1996) *Sawyer's Internal Auditing*, 4th edition, Florida: The Institute of Internal Auditors, p. 8.

3. Internal Auditing (2002) *Distance Learning Module*, Institute of Internal Auditors UK&Ireland.
4. Moeller, Robert and Witt, Herbert (1999) *Brink's Modern Internal Auditing*, 5th edition, New York: John Wiley and Sons Inc.
5. Sawyer, Lawrence B. and Dittenhofer, Mortimer A., assisted by Scheiner James H. (1996) *Sawyer's Internal Auditing*, 4th edition, Florida: The Institute of Internal Auditors, p. 13.