

Brink's Modern Internal Auditing

SUBSCRIPTION NOTICE

This Wiley product is updated on a periodic basis with supplements to reflect important changes in the subject matter. If you purchased this product directly from John Wiley & Sons, Inc., we have already recorded your subscription for this update service.

If, however, you purchased this product from a bookstore and wish to receive (1) the current update at no additional charge, and (2) future updates and revised or related volumes billed separately with a 30-day examination review, please send your name, company name (if applicable), address, and the title of the product to:

Supplement Department
John Wiley & Sons, Inc.
One Wiley Drive
Somerset, NJ 08875
1-800-225-5945

For customers outside the United States, please contact the Wiley office nearest you:

Professional & Reference Division
John Wiley & Sons Canada, Ltd.
22 Worcester Road
Rexdale, Ontario M9W 1L1
CANADA
(416) 675-3580
1-800-567-4797
FAX (416) 675-6599

John Wiley & Sons, Ltd.
Baffins Lane
Chichester
West Sussex, PO19 1UD
UNITED KINGDOM
(44) (243) 779777

Jacaranda Wiley Ltd.
PRT Division
P.O. Box 174
North Ryde, NSW 2113
AUSTRALIA
(02) 805-1100
FAX (02) 805-1597

John Wiley & Sons (SEA) Pte. Ltd.
37 Jalan Pemimpin
Block B a 05-04
Union Industrial Building
SINGAPORE 2057
(65) 258-1157

Brink's Modern Internal Auditing

Fifth Edition

ROBERT R. MOELLER

HERBERT WITT

JOHN WILEY & SONS, INC.

New York x Chichester x Weinheim x Brisbane x Singapore x Toronto

This book is printed on acid-free paper. √

Copyright © 1999 by John Wiley & Sons, Inc. All rights reserved.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4744. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 605 Third Avenue, New York, NY 10158-0012, (212) 850-6011, fax (212) 850-6008, E-Mail: PERMREQ @ WILEY.COM.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

Library of Congress Cataloging-in-Publication Data:

Moeller, Robert R.

Brink's modern internal auditing.—5th ed. / Robert R. Moeller,
Victor Z. Brink.

p. cm.

Rev. ed. of: Modern internal auditing / Herbert Witt. 4th ed. c1982.

Includes bibliographical references and index.

ISBN 0-471-52132-9 (cloth : alk. paper)

- I. Auditing, Internal. I. Brink, Victor Zinn, 1906—
- II. Brink, Victor Zinn, 1906— Modern internal auditing.
- III. Title.

HF5668.25.B74 1998

657'.458—dc21

98-20229

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ABOUT THE AUTHORS

Robert R. Moeller has over 25 years experience in internal auditing, ranging from launching new internal audit functions in several companies to serving as audit director for a Fortune 50 corporation.

Moeller has an MBA in finance from the University of Chicago and an undergraduate degree in engineering; he has accumulated a wide range of professional certifications including the CPA. He was appointed the National Director of Computer Auditing for the major public accounting firm of Grant Thornton. There he developed firm-wide audit procedures and directly managed information systems audits. He eventually assumed responsibility for their Chicago office information systems consulting practice, leading projects to build and install systems for a wide range of clients.

In 1989, Moeller was recruited to build and organize the first corporate information systems audit function for Sears Roebuck. He went on to become their audit director, initiating numerous new practices to their internal audit department. He has been active professionally in both the Institute of Internal Auditors and the AICPA. He was president of the IIA's Chicago chapter, served on its International Advanced Technology Committee, and was chair of the AICPA's Computer Audit Subcommittee.

In 1996, Moeller launched his own corporation, Compliance and Control Systems Associates, Inc., and presented seminars on internal controls and corporate governance throughout the United States. He has worked as a consultant and project manager, specializing in the telecommunications industry; has helped develop controls for a major cellular telephone billing system; has managed a year 2000 project for AT&T; and most recently managed a cellular telephone financial system project on a worldwide basis.

Herbert Witt was formerly with Price Waterhouse and with the Department of Health and Human Services Office of Inspector General. He received an MBA degree from the University of California, Berkeley, and is a Certified Public Accountant, a Certified Internal Auditor, and a Certified Government Financial Manager. He was co-author of the American Institute of Certified Public Accountants course in Operational Auditing. Witt is the former Regional Vice-President, Regional Director, and National Director of the Institute of Internal Auditors. He also served as Chairman of the IIA's International Research Committee and the International Education Committee.

PREFACE

In 1941, the clouds of war—initiated by such dictators as Hitler, Mussolini, and Stalin—were surrounding much of the world. At the same time, Victor Z. Brink completed his New York University Ph.D. thesis. While the “maximum leader” dictators were predicting one kind of violent revolution, Brink’s Ph.D. thesis outlined a much more benign revolution, a revolution in the way that internal auditors should perform their work. Prior to the 1940s, internal auditors were essentially in-house assistants to their company’s public accounting firms, performing little more than clerical financial auditing support duties for those external auditors. Brink’s thesis argued that a much better role for internal auditors should be as servants to management, not as external auditor assistants.

Vic Brink then went off to service in World War II, but not before the wheels were put in place to publish his thesis as a book for business leaders. Its title was *Modern Internal Auditing*. With the United States gearing up for total war and looking to better utilize every scarce resource, the first edition of *Modern Internal Auditing* (1942) caused many managers to consider how they might better organize their internal audit functions. Brink’s book strongly proposed that internal auditors could and should be much more significant members of an organization’s management team. The *modern* internal auditor that Brink envisioned served management by going beyond routine accounting verification procedures and taking a broader approach of *supplying service to management* as part of their internal audit activities. This approach came to be known as *operational auditing*.

Brink returned from the war and became director of internal audit for the Ford Motor Company. He also worked with others, such as Brad Cadmus and Larry Sawyer, to expand and better define this new professional called the modern internal auditor. A final result of the work of Brink and others was the establishment of the Institute of Internal Auditors (IIA), now a major professional accounting organization, responsible for setting standards and providing guidance to the profession of internal auditing.

Often, authors of significant and groundbreaking business books “go to sleep” after their first or second editions. However, Brink kept active in the profession, revising his original 1942 edition three times over the years, either by himself or in collaboration with Herbert Witt in the last editions. Because Herbert Witt worked on the two most recent revisions, some of his ideas and expression remain in the book and his name properly continues its association with this edition. Although Brink introduced new concepts and technologies in the subsequent editions, he never lost his basic philosophy that internal auditing should provide a basic and essential *service to management* in the modern organi-

zation. In this edition of *Modern Internal Auditing*, author Robert Moeller takes full responsibility for taking Brink's philosophy into today's world.

Until his death in 1992, Brink continued to be alert and professionally active. I met Brink at an IIA annual international conference as well as several times after this new edition was launched. He was an impressive, interesting man, with an ongoing concern for the practice of internal auditing. This fifth edition preserves Brink's important concept of internal audit's responsibility to management but also introduces many of the changes and concepts that continue to make internal auditing exciting and important.

Although changes have taken place in many areas, it's the growth of computers and information systems that perhaps best illustrates how changes have impacted internal auditors over the last 50 to 60 years. At the time of the first edition of *Modern Internal Auditing*, the digital computer did not exist and companies were just beginning to use 80- or 90-column punched-card tabulating equipment for some of their elementary statistical record-keeping applications. There was no need to mention these machines in the first edition of this book because they were just not that important to businesses.

Mainframe computers, behemoths that weighed tons and occupied major areas of floor space, were introduced in larger companies starting in the 1960s, but internal auditors were not concerned with them. This was the era in which audits were performed *around* the computer; that is, if a total had been generated by the computer and printed on some report, it was assumed to be correct because "the computer figured it out." Auditors were primarily concerned that the input controls were adequate. Internal auditors had little to do with these computer systems besides perhaps checking to see if the door to the computer room was locked or that candy and soft drinks were not being consumed in the computer room.

Business data processing systems became more pervasive with IBM's introduction of its 360 series in the mid-1960s, and internal auditors began to pay a little more attention to them. They began to pay a *lot* more attention when news broke of a computer-based fraud in the early 1970s involving a company called Equity Funding. Suddenly, the profession of computer auditing was launched, but these specialized computer auditors were viewed as out of the mainstream of normal internal audit activities. Previous editions of *Modern Internal Auditing* gave little attention to computer systems and their controls.

By the late 1970s, the classic mainframe computer was common to larger organizations and smaller "minicomputers" were beginning to be introduced to others. Internal auditors, through their use of audit retrieval languages and their greater understanding of information systems controls, began auditing and testing the adequacy of controls surrounding these new business tools. This was the era when an organization's security function was primarily involved with parking lot slots and building gates. Management began to view internal auditors as computer security experts, an example of how internal audit's service to management has yielded positive results.

Mainframes and their smaller micro- and minicomputer versions became pervasive by the end of the 1980s. The modern internal auditor had to better understand these machines and their control risks. The fourth edition of *Modern Internal Auditing* (1982) devoted a whole chapter to computer systems, although the material seems elementary today. By that time, internal auditors were concerned with computer system control issues in their accounting and general business audit areas, but were still not generally using computer systems to automate internal audit practices.

As we enter the next millennium, automation in all of its forms has become common for all areas of operations. Networks of computer systems are used throughout the organiza-

tion, and today's modern internal auditor will typically go on an audit assignment armed with a laptop computer that will allow the auditor to: (1) record workpaper interviews; (2) perform various financial and statistical analyses; (3) communicate with the home office via modem; and (4) look up reference information on the Internet. As a result, this new edition has five chapters devoted to information systems and their impact on internal auditors.

This edition is divided into six major parts, organized as follows:

Part One—Foundations of Internal Auditing. Four chapters here describe what internal auditing is really all about. The origins of the profession are discussed in Chapter 1 and the basic or fundamental concepts of internal control in Chapter 2. The broader definition of internal control, as defined in what has been called the Committee of Sponsoring Organizations (COSO) report, is discussed here. Part One in general, and Chapter 3 in particular, describes the importance of internal audit's service to management as part of its overall approach. Chapter 4 describes the operational approach of an internal auditor, as opposed to the more traditional "Do the debits equal the credits?" approaches of many traditional financial auditors. Of course, as the reader will discover throughout this edition, this more operational approach of assessing and evaluating controls is being more frequently used by all auditors, whether they be internal or external. Finally, Chapter 5 covers the Standards for the Professional Practice of Internal Auditing, issued by the Institute of Internal Auditors. These are the standards that should govern activities of *all* internal auditors. They are important for understanding the basic foundations of the profession of internal auditing. While earlier editions contained the complete text, Chapter 5 contains extracts from the actual text of the standards as well as explanatory comments; references to these standards will be found throughout the other chapters of this edition.

The chapters in Part One should give the reader a general understanding of what internal audit is and what an internal audit function can do for an organization. Taken by itself, this part can be useful reading for the nonauditor (for example, a member of senior management) who wants to have a general understanding of internal audit's purposes and objectives. Even though internal auditors have been in the modern organization since about the time of Vic Brink's first edition, there are still some managers who do not fully understand the purpose and roles of the modern internal auditor. Things have become, perhaps, even more confusing with other professions now having specialists who call themselves "auditors."

Part Two—Administering Internal Audit Activities. The 10 chapters in this Part all discuss alternatives and recommended practices of how a modern internal audit function should be organized. The modern internal audit organization is an independent entity within the company and should be of service to all levels of the organization. Internal audit reports problems, suggests solutions, and acts as an overall evaluator. In order to maintain its independence, internal audit should report not to the CFO or some other member of management. Rather, the board of directors' audit committee is often the best independent authority to oversee a modern internal audit function, and Chapter 6 provides guidance on how to set up that reporting relationship, along with sample board-authorizing resolutions and internal audit reports.

Chapters 7, 8, and 9 discuss, respectively, organizing the internal audit activity, evaluating various risks to allow internal audit to better plan audit projects, and staffing the internal audit function. These chapters provide some basic guidance on building an effective internal audit organization, evaluating organizational and audit risks, and recruit-

ing and training an internal audit staff. Evaluating audit risk, as covered in Chapter 8, is an important concept for all professionals involved in the audit process. Whether an audit manager looking at all entities and activities in the organization and developing an overall annual audit plan from this analysis or a staff member on a field assignment deciding on specific areas to investigate, internal auditors need a consistent approach to evaluating risks. Risk analysis allows internal audit to devote its always limited audit resources to the higher, more significant risk areas.

The effective internal audit function must spend significant amounts of its audit evaluation time in the “field”—the various local and remote locations and organization activities. Although much can be accomplished through review of records on computerized databases and published reports, the effective internal auditor still needs to observe operations. Chapter 9 discusses ways to select people with appropriate skills to build an effective internal audit organization, approaches to provide them with ongoing training, and considerations for evaluating auditor effectiveness. Chapter 10 then provides approaches to managing that internal audit organization, particularly when auditors are working in the field. These two chapters are valuable for audit managers, from supervisor to director, as well as for staff auditors who have management aspirations.

A crucial part of the audit process is the auditor’s documentation, which should include records of interviews, the results of tests performed, and other evidence supporting the audit work. This documentation is gathered together in what are called auditor “workpapers,” whether they be handwritten notes or computer-based files and reports. Chapter 11 discusses several approaches to prepare workpapers that effectively document all audits.

The computer is an invaluable tool for internal auditors. Chapter 12 discusses ways to develop computer-assisted audit procedures to allow the internal auditor to better analyze and evaluate computerized data. Even when using computer-assisted audit techniques, auditors are often faced with large volumes of audit evidence. Rather than examining all of this material or making arbitrary selections from it for audit tests, Chapter 13 discusses how to use audit or statistical sampling techniques to select appropriate samples of the audit data and then how to develop conclusions based upon the sample results. Finally, internal auditors historically have not taken advantage of computerized tools to better manage their own internal audit administrative work. Chapter 14 provides both suggestions and examples of reports developed to automate internal audit processes.

A formal report of an internal auditor’s work—an audit report summarizing what was observed and what was found, and giving recommendations for improvement—is one of the most important functions of the internal audit process. Chapter 15 discusses different formats for audit reports and good, general techniques for communicating internal audit efforts. This chapter contains several examples of effective audit reports.

The ten chapters in this part should be useful for all members of the internal audit organization. They build on material found in the previous editions and provide guidance on building an effective internal audit department.

Part Three—Impact of Information Systems on Internal Auditing. The internal control implications of computer systems in the modern organization is an example of how this edition has changed from previous editions. The five chapters in Part Three provide background and help for internal auditors in this rapidly evolving field.

Chapter 16 covers reviews of data processing operations, reviews that were once limited to classic mainframe computer systems. This chapter discusses changes in these

review techniques due to newer hardware and processing technologies, the growth of telecommunications, and the use of sophisticated systems in all areas of operations.

Computer hardware or equipment is of little value unless it uses effective computer programs, or applications. Chapter 17 discusses approaches to reviewing and evaluating controls in computer business applications while Chapter 18 discusses approaches for auditing newer systems under development. Although the concept of developing applications was once thought of as the process of writing programs from scratch—such as an organization writing its own payroll program—today we normally purchase software components. Auditors continue to have an important role in reviewing the controls that are built into these applications as well as the management controls over the projects necessary to implement them.

Chapter 19 discusses audit procedures for reviewing physical security, logical security such as the use of passwords, and contingency planning procedures. Contingency planning refers to the procedures that should be in place to get an organization's information systems back in operation after an unexpected and extended outage of some sort. This chapter discusses contingency planning both for the classic mainframe or centralized computer systems as well as for the newer networked or client-server systems.

Part Three ends with a chapter on new and evolving computer systems technologies and some of the internal audit concerns associated with these technologies. This message is always difficult in this type of book as technologies evolve and in some cases all but disappear very quickly. Chapter 20 looks at a series of issues that appear to be on the horizon and which may soon impact internal auditors in their reviews of internal controls.

Part Four—Areas for Operational Auditing. As discussed, Brink's original book introduced the concept of operational auditing to a world where people known as internal auditors did little more than test fairly basic financial controls. Prior editions—as well as this one—introduce operational concepts in various functional areas to help the internal auditor hone in on specific areas of potential control concern. Part Four contains ten chapters that provide some specific internal audit control review guidance in important areas of operations. After Chapter 21, which provides a general introduction to planning and performing an operational review, the chapters in Part Four are as follows: Chapter 22, Accounting Systems and Controls; Chapter 23, Manufacturing Production Planning; Chapter 24, Purchases, Receipts, and Electronic Data Interchange; Chapter 25, Distribution and Transportation; Chapter 26, Engineering, Research, Quality, and Quality Control; Chapter 27, Fixed Assets and Capital Projects; Chapter 28, Sales, Marketing, and Advertising; Chapter 29, Payroll and Personnel; and Chapter 30, Financial Management.

Each of these chapters provides a description of the specific operational areas and then takes on the audit issues associated with the area, dividing them between financial, operational, and information systems audit concerns. Tables of suggested audit procedures or questionnaires, as appropriate, are included in each chapter. In addition, most chapters contain suggested audit report findings and recommendations in specific operational areas. The audit report comments should help internal auditors to develop better report comments in their own operational reviews.

These materials represent a major addition to this new edition; prior editions provided more general guidance, but this new edition gives some detailed materials that the staff or senior internal auditors can use to develop specific audit programs.

Part Five—Special Audit Activities. The world of internal auditing is constantly changing and expanding. Part Five covers three of these areas. Chapter 31 discusses loss prevention and fraud investigations. Historically, internal auditors did not get much in-

volved with fraud-related investigations. With the elimination of traditional company security functions in today's leaner, more efficient organization, internal audit is often called in to help with loss prevention and fraud-related activities. Chapter 32 then discusses coordination with external auditors. These two audit groups have always worked together, but today standards are in place on both sides to make this process more formal and expansive. Finally, Chapter 33 discusses internal audit quality assurance reviews. This chapter tries to answer the old question, "But who audits the auditor?"

Part Six—Internal Audit Future Directions. The scope of modern internal audit activities is always changing and often expanding. This Part examines it from three directions. Chapter 34 considers the overall changing role of audit activities. Internal audit was once essentially limited to formal audit activities, resulting in traditional audit reports; this chapter looks at how the role of internal auditing is expanding. Vic Brink's *service to management* concept is readily accepted at face value today, and auditors are being asked to operate in a variety of expanded roles. In addition, the public today takes a much more critical view of business practices than in the past. Finally, Chapter 35 discusses the evolving field of business ethics and the social responsibilities of organizations as well as the potential role of internal auditors in this whole process.

There have been many changes in the profession of internal auditing in the over 50 years since Vic Brink published his first edition. Brink's emphasis on *service to management* and the efforts of others in the profession to promote this type of duty have done much to make internal auditing a vital, important part of the modern organization. An objective of this edition is to promote that concept and to provide help for internal auditors to build and develop new tools and skills to allow them to be even more effective in internal audit activities.

CONTENTS

PART ONE FOUNDATIONS OF INTERNAL AUDITING

- 1 Foundations of Internal Auditing
- 2 Fundamentals of Control
- 3 Understanding Management Needs
- 4 Operational Approach of Internal Audit

PART TWO ADMINISTERING INTERNAL AUDIT ACTIVITIES

- 5 Professional Standards
- 6 Serving the Audit Committee of the Board
- 7 Evaluating Organization and Audit Risk
- 8 Organizing and Planning Internal Audit Activities
- 9 Internal Audit Staffing, Training, and Evaluating
- 10 Directing and Performing Internal Audits
- 11 Preparing Workpapers to Document Audit Activity
- 12 Using Computer-Assisted Audit Techniques
- 13 Gathering Evidence Through Audit Sampling
- 14 Automating Internal Audit Processes
- 15 Audit Reports and Internal Audit Communication Techniques

PART THREE IMPACT OF INFORMATION SYSTEMS ON INTERNAL AUDITING

- 16 Information Systems Operations Controls
- 17 Information Systems Application Controls
- 18 Auditing Systems Under Development

xiv Contents

- 19 Physical, Logical Security, and Contingency Planning
- 20 New and Evolving Information Systems Technologies

PART FOUR AREAS FOR OPERATIONAL AUDITING

- 21 Introduction to Operational Auditing
- 22 Accounting Systems and Controls
- 23 Manufacturing Production Planning
- 24 Purchases, Receipts, and Electronic Data Interchange
- 25 Distribution and Transportation
- 26 Engineering, Research, Quality, and Quality Control
- 27 Fixed Assets and Capital Projects
- 28 Sales, Marketing, and Advertising
- 29 Payroll and Personnel
- 30 Financial Management

PART FIVE SPECIAL AUDIT ACTIVITIES

- 31 Loss Prevention and Fraud Investigation
- 32 Coordination with External Auditors
- 33 Internal Audit Quality-Assurance Reviews

PART SIX INTERNAL AUDIT FUTURE DIRECTION

- 34 Changing Role of Audit Activities
- 35 Business Ethics and Social Responsibility

INDEX

PART ONE

FOUNDATIONS OF INTERNAL AUDITING

CHAPTER 1

Foundations of Internal Auditing

1-1 WHAT IS INTERNAL AUDITING?

There is no better way to begin this book about modern internal auditing than to refer to the Institute of Internal Auditors (IIA), the professional association of internal auditors. The IIA's Standards for the Professional Practice of Internal Auditing contain the following definition:

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 the key terms. *Auditing* suggests a variety of ideas. It can be viewed very narrowly, as the checking of arithmetic accuracy or physical existence of accounting 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 to high-level 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 the particular organization.

The remainder of the IIA's statement covers a number of important terms that apply to internal auditing work. For example:

- x *Independent* is used for 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.
- x *Appraisal* confirms the need for an evaluation that is the thrust of internal auditors as they develop their conclusions.
- x *Established* confirms that internal audit is a formal, definitive function in the modern organization.

- x *Examine and evaluate* describe the active roles of internal auditors, first for fact-finding inquiries and then for judgmental evaluations.
- x *Its activities* confirm the broad jurisdictional scope of internal audit work that applies to all of the activities of the modern organization.
- x *Service* reveals that help and assistance to management and other members of the organization are the end products of all internal auditing work.
- x *To the organization* confirms that internal audit's total service scope pertains to the entire organization, including all personnel, the board of directors and their audit committee, stockholders, and other owners.

A better understanding of internal auditing can be obtained by recognizing that it is 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 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 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 and 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 various 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 HISTORY

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, had no need for computer systems specialists. Aside from some electromechanical devices and activities in research laboratories, the computer system 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. 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 also understand better 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 of the 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 all operations to satisfactorily review the effectiveness of 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, that same manager will find it increasingly difficult to know whether the interests of the organization are being properly served as the organization 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 above-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 viewed as a closely related extension of the work of external auditors.

The result of all of these factors was that early internal auditors were viewed as playing a relatively narrow role in their organizations, with relatively limited responsibility in the total managerial spectrum. An early internal auditor 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 the mathematics in regular business documents. In retail organizations, internal auditors often were responsible for reconciling daily cash sales to register receipts.

Understanding the history of internal auditing is important because the old image still exists to some extent for modern internal auditors. This is so even though the character of the internal auditing function is now very different. Over a period of 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 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 initial—internal auditors began to question the overall control process they were reviewing. Subsequently, internal audit evaluation work was extended to include many nonfinancial areas in the organization.

In 1942, 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 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 and has resulted in the type of modern internal auditor discussed in this edition of Brink’s original book.

New business initiatives, such as the COSO internal control standards discussed in Chapter 2 or the Foreign Corrupt Practices Act of the late 1970s, 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. The need for ethical standards includes higher standards for corporate management, greater involvement of boards of directors (including their audit committees), a more active role for stockholders, and greater independence of the outside public accountant. Ethics and social responsibility issues will be discussed in Chapter 35. 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 organization 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 60,000 members and 200 local chapters worldwide. At the same time, the importance of internal audit has been recognized by external auditors through their auditing standards, as will be discussed in Chapter 32. 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. In most 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. In some other organizations, internal audit is functioning 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, internal audit has expanded its activities to all operational areas of the organization and has established itself as a valued and respected part of the top management effort. To an increasing extent, the modern internal auditor is actively serving the board of directors, usually via its audit committee. While internal audit organizations once had an almost nonexistent, dotted line reporting relationship to the audit committee—with little direct communication—the director of internal audit in many organizations today has an 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 6.

(a) COMPOSITE NATURE OF OPERATIONAL AND FINANCIAL AUDITING

During the 1960s, there was a strong tendency for many to adopt the label 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 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 procedural controls and ignore the issue of whether the cash received was properly recorded in correct accounts. Management often became confused and dismayed when their internal auditors all but ignored important accounting or financial-related issues.

This separation of responsibility involved matters of both substance and self-interest for the *operational audit*-oriented internal auditors. Traditionally, internal auditors had been concerned with accounting and financial matters, and some expertise in these areas had generally been considered to be essential. The coverage of these matters had also served to provide an opportunity for expanding the range of internal audit services into the broader operational areas. Since accounting or financial records directly or indirectly reflect all operational activities, financially oriented reviews performed by internal auditors open the door to the other activities. This type of extension has been most advantageous, and the combination of operational and financial 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, for example, will discuss how many traditional internal auditors ignored the International Standards Organization (ISO) "quality" movement in its early days, leading to an almost separate profession of quality standards auditors. An organization certainly needs to have someone covering the 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 is one of the arguments external audit firms may make to senior management when they seek to provide internal audit outsourcing services. Therefore, internal audit needs to cover accounting and financial areas for their own self-interest, if for no other reason. Internal audit outsourcing will be discussed in Chapter 34, which deals with internal audit's changing role and future prospects.

Some internal audit functions will feel that a continuing connection with financial auditing hinders their effort to adequately reach the potentials of operational auditing. They will argue that external auditors can more appropriately cover areas of financial control risk. Other internal audit functions prefer to perform work in both areas but to deal with them separately. On balance, however, there is an important linkage between the so-called financial and nonfinancial areas, and it is desirable to recognize and to take advantage of that linkage. Similarly, what were once called *EDP auditors* (or information systems auditors) should not operate separately and independently from other internal

audit activities. All internal audit efforts should be shaped, with specialized types of emphasis, to serve overall organizational needs in the most effective manner possible. Therefore, operational, financial, and information systems auditing should be able to find a full expression within the framework of modern internal auditing. There should no longer be operational, financial, or computer auditors, but only good modern internal auditors.

1-3 INTERNAL AUDITING IN TODAY'S ORGANIZATION

A better understanding of the nature of internal auditing comes by examining the relationship between internal auditing and the organization's other activities. The work of internal audit needs to be detached from the regular day-to-day operations of the organization. A good practical test is that if internal auditing activity were to be temporarily inactivated, either partially or completely, regular organization operations should be able to continue in their normal manner. The reasons for detachment are very practical. To the extent that the internal auditing group is charged with day-to-day activities such as validating disbursements, reconciling bank accounts, approving movements of assets, and the like, internal audit's separate and supplementary review has ceased to exist. Instead, internal audit activities have simply taken the place of regular accounting or other operational responsibilities.

At times, management may be tempted to assign operational responsibilities to internal audit, but when this is done, the result is the loss of internal audit's independent review. The effective modern internal audit function must recognize its relation as an important *independent* entity with strong relationships to the audit committee of the board of directors, to the external auditors who are hired by the board and who have special responsibilities to the outside, and to organization management.

(a) RELATIONSHIP OF INTERNAL AUDIT WITH THE BOARD OF DIRECTORS

As a result of the previously mentioned environmental pressures, boards of directors today play a more active role and assume increased responsibilities in their relationships with organization management, the stockholders, and other stakeholders. One of the ways in which the board has coped with its increased responsibilities is through the expansion of the role of its audit committee. Although this role is continually evolving, it normally includes an overview of the completeness and integrity of the financial statements, the effectiveness of the system of internal control, and the adequacy of the total audit effort. Assessing the total audit effect requires relations with both the independent auditors and internal audit. Although the more usual arrangement is for internal audit to report administratively to either the chief executive officer or chief financial officer, the need also exists for defined reporting and assistance to the audit committee. As will be discussed in more detail in Chapter 6 and other chapters, internal audit customarily has a dual relationship with organization management and the audit committee. In both relationships, internal audit must appropriately coordinate its work with that of the independent public accountant—the external auditors.

(b) RELATIONSHIP OF INTERNAL AUDIT WITH THE EXTERNAL AUDITORS

As previously discussed, the earlier view of internal auditing was as an extension of the external audit effort. In many cases, early internal auditing programs were designed by

the organization's external auditors primarily to assist the needs of that outside audit function. Internal auditing personnel were frequently recruited from the public accounting profession and their approach was often oriented to public accounting auditing standards and interests. Internal audit and their management now generally recognize that despite certain common interests, internal and external audit priorities are quite different. External auditors have a primary responsibility to parties outside the client organization, while internal auditors have a primary responsibility to the organization. An external audit is interested more specifically in the soundness of the financial statements, whereas an internal audit is concerned predominantly with the overall effectiveness of the company operations, its control procedures, and resulting profitability. The situation becomes a little more complex, however, when senior management contracts with an external auditing firm to provide them with internal audit services through an outsourcing arrangement. Internal audit outsourcing will be discussed in Chapter 34.

Although both audit groups have different primary missions, there are many common interests that provide the basis for extensive coordination efforts, which will be discussed in more detail in Chapter 32. These common interests stem from the fact that the soundness of the organization's system of internal control is an important basis for each group's achieving its primary mission. This relationship has become especially important because of such actions as the requirement in the Foreign Corrupt Practices Act of 1977 (FCPA) that corporations maintain a system of sound internal accounting control, and the U.S. Securities and Exchange Commission requirements for a report from management covering the adequacy of their system of internal control. Newer internal control requirements, often called COSO report standards, as well as the FCPA and other internal control standards, will be discussed in Chapter 2.

(c) RELATIONSHIP OF INTERNAL AUDIT WITH ORGANIZATION MANAGEMENT

Internal auditors must recognize that they occupy a staff function in the organization, and should never attempt to usurp the roles and responsibilities of other departments or individuals. Line management should have the basic responsibility for their own particular sphere of the operations and this responsibility should never be shifted to internal audit. This does not mean that internal audit should be without responsibility. Internal audit has a strong responsibility to do a job that is competent in a professional sense. If internal audit were to relieve line personnel of their responsibilities, this would weaken the motivation of the line managers and lessen the value of their roles. Thus, the findings and recommendations of internal audit should always be informative and advisory, and should in no way carry any direct authority to command specific actions. Such authority must be determined by the line personnel, based on the soundness and persuasiveness of the particular audit findings and recommendations.

There will always be an unavoidable overlap of internal audit's role with other organization activities. In principle, all personnel in an organization should be committed to doing their particular jobs effectively and helping to achieve maximum organization welfare. This commitment increases as one goes up the organizational ladder, including the various staff areas. Thus, a financial analysis group, a quality assurance group, or some other staff function might be very much concerned with operational analysis and assistance. Frequently, special task forces will be created as well to study designated organizational problems. What, then, is so unique about the role of internal audit in provid-

ing analysis and service? The answer here is that internal audit is the *one function* in the modern organization that is completely detached from both the operational components and functional staff groups (such as finance or marketing), and that can look at the various problems independently and in terms of overall control procedures.

Internal audit's competence in the analysis of internal control systems, as well as their understanding of the design and implementation of controls, gives them a needed credential to round out their overall professional capabilities. No other group in the organization so well combines the fact of detachment, the objectives of organizational service to the organization, and the major competence in the field of control.

1-4 FUTURE DIRECTIONS

The development of the profession of internal auditing has largely been centered in business organizations. Although this tie continues in the treatment of many internal control problems within the framework of business organizations, it unduly denies the universal applicability of internal auditing to all types of organizations. Moreover, this view fails to recognize that some of the most progressive internal auditing is now being done by non-business types of organizations. The federal government auditors in the General Accounting Office (GAO) as well as defense contract auditors both conduct sophisticated audits. Subsequent chapters will attempt to incorporate and discuss some of these techniques, where appropriate.

A related fact here is that many organizations are a blend of business and nonbusiness activities. For example, a governmental entity such as the New York Port Authority has been created and charged with the responsibility for operating public-service facilities as a business. Other similar examples exist within the U.S. federal government. All of these developments confirm that the need for internal auditing exists in all types of organizations where the complexity of the activities, the volume of transactions, and the dependence on large numbers of people exist in some combination to create operational problems. Organizations can exist for a variety of purposes, but there are always tasks to be performed and objectives to be achieved. All organizations should have a common objective to utilize their available resources in the most productive manner possible to achieve overall organizational objectives. In that endeavor, all responsible managers require effective internal control mechanisms and can utilize the assistance of internal audit.

Thus, all types of organizations have a need for internal auditing services, and there is a common body of professional knowledge that applies to all of these varied internal audit activities. Another aspect of internal audit's universal applicability is that there is potentially a need for the services of internal audit at any organizational level in any particular organization. This means there are legitimate needs for internal auditing services by the stockholders, the board of directors, and by the responsible management. The controlling principle here is that whenever organizational responsibilities are established, there are potential needs for internal auditing services, which should be provided in some way and at some level.

All of an organization's needs might be served by a central internal audit group, provided that the central group can structure and administer the total operation in a sufficiently competent manner. In other cases, organizational components may be best served by an internal auditing group of their own that is directly responsible to the central group. What is important, however, is that internal auditing needs are directly linked to all organi-

zational components. The organization of internal audit activities will be discussed in Chapter 7, Evaluating Organization and Audit Risk.

This chapter has described the background and development of the profession of internal auditing, how the modern internal auditor serves management at all levels, and how this management service should apply to all organizational activities. The following chapters will discuss how an internal audit function might be organized and how modern internal auditors can perform effective reviews in a large variety of areas.

