

# **INTERNAL AUDITING**

## **PRINCIPLES and TECHNIQUES**

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**Wanda A. Wallace, Ph.D., CIA, CPA, CMA**  
**James K. Loebbecke, CPA**  
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**The Institute of Internal Auditors**

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**The Institute of Internal Auditors**  
**Altamonte Springs, Florida**

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# Foreword

The Institute of Internal Auditors has a primary responsibility to research, disseminate, and promote knowledge and information concerning internal auditing including internal control and related subjects. The benefits of this work are not limited to the 30,000 practitioners worldwide who are members of The IIA. As a student of internal auditing today, you are the practitioner of tomorrow, and it is critically important that you receive a solid foundation in the fundamentals of the profession. That's why, nearly five years ago, we commissioned *Internal Auditing: Principles and Techniques*.

The major focus of this book is risk, for risk is the primary consideration in determining what is audited and how audits are performed. In view of recent developments including rampant exposures of fraud and financial mismanagement, internal controls and risk assessment are more important than ever in the practice of internal auditing.

For those who are about to enter the profession of internal auditing, as well as those who are already practicing, a complete understanding of the risk-driven audit process is absolutely essential. *Internal Auditing: Principles and Techniques* is designed to provide that knowledge, as well as a complete overview of audit skills, applications, standards, and more.

When The Institute of Internal Auditors was founded in 1941, we chose "Progress Through Sharing" as our motto. This book has certainly put that motto into practice. We feel it is our responsibility to share knowledge with our colleagues as well as those who are on the brink of entering our increasingly important profession. We hope that you will benefit from this knowledge.

On behalf of The Institute of Internal Auditors, I would like to express our appreciation to the authors, Richard L. Ratliff, Ph.D., CIA; Wanda A. Wallace, Ph.D., CIA, CPA, CMA; James K. Loebbecke, CPA; and William G. McFarland, CPA, for their enthusiasm and perseverance with this project. Their contributions will surely lead you, the students of today and the practitioners of tomorrow, to a greater appreciation of the theory and applications of internal auditing.

Ronald L. Bell, CIA  
Chairman of the Board  
The Institute of Internal Auditors  
1987-88

# Preface

Students of internal auditing deserve a solid foundation in its theory and applications. This textbook, almost five years in the making, has been written with this primary focus in mind. The increase in the number of colleges and universities offering internal auditing courses, and the scarcity of teaching materials, prompted The Institute of Internal Auditors (IIA) to produce a textbook suitable for these courses and adaptable to a variety of teaching methods and course demands.

We have assumed that readers have completed a set of introductory business and economics courses, including microeconomics, basic financial and management accounting, marketing, management, corporate finance, computerized management information systems, and statistics. For this reason, we assume that most students studying this text are at least college juniors. The text may be used for upper-level undergraduate or masters-level courses.

The fundamental thesis of the text is that internal auditing is risk-driven. Risk is the primary consideration in determining what is audited and how audits are performed. The text discusses in detail a generalized audit process designed to provide the flexible structure necessary to allow risk to drive the process.

We have tried to keep faith with both the letter and the spirit of The Institute of Internal Auditors' official pronouncements, in the belief that these pronouncements have set a high standard for professional performance. We have also tried to provide room for adaptation to individual organizations.

The manuscript has undergone extensive review by college faculty members, internal auditing practitioners, and students. Much of the material has been presented to various professional seminars for discussion and evaluation. We believe that this material represents a reasonable consensus of what internal auditing is, but perhaps more importantly, an ideal of what it can be.

The text is divided into four major sections and includes three appendices. Section I introduces internal auditing, professional standards, and some basic concepts, including internal control systems and audit evidence. This section provides an important foundation for information included later in the text. Section II presents a detailed discussion of the general audit process and its management. Section III discusses three technical areas and skills that are important to internal auditors — human relations, sampling, and quantitative methods. Section IV discusses specific types of audit applications, including general operational, performance, compliance, financial, electronic data processing (EDP), and fraud auditing.

Appendix I outlines typical internal controls and sources of audit evidence for a few representative systems common to most organizations. These systems include marketing and

sales, accounts and notes receivable, purchasing and receiving, inventory management, personnel and payroll, production and cost accounting, and facilities and equipment. Internal control systems for cash receipts and disbursements and for EDP systems are discussed in Chapters 16 and 17, respectively.

Appendix II reproduces The IIA's *Professional Standards Bulletins* for easy reference.

Appendix III includes individual case materials, each requiring approximately 12 to 25 hours to complete. These cases are designed as term projects. Most instructors are likely to assign between one and three of these cases in any one course of study. The five cases are provided to offer a selection that will be suitable to varying course needs.

We doubt that any one internal auditing course will cover all of the material presented in the text. Because of the varying course needs, we expect instructors to choose from the materials in order to best achieve their individual course objectives.

One course outline that has proven effective for an introductory upper-level undergraduate course covers Sections I and II, with one assigned case study from Appendix III. Where a second course is taught, Sections III and IV would be appropriate, with the remaining cases. Of course, additional readings from current periodicals also may be helpful. The text is designed as a self-contained unit and no additional materials are required, except as desired by the instructor.

We wish to thank the many college faculty members, internal auditing professionals, and students who have aided immensely in the preparation of this textbook. We especially wish to thank the late Leon Radde, CIA, CPA, former chairman of the board of The Institute of Internal Auditors, whose patient encouragement and high expectations were most valuable. We also wish to thank John Dattola, director of professional development for The Institute of Internal Auditors, and Karen Brogan, IIA editor, who orchestrated the book's production. We appreciate the valuable feedback provided by our review committee, including Dr. Glenn E. Sumners, John J. Fernandes, Dr. Thomas A. Gavin, Joe P. Marusak, and Chris P. Neck. Many students have spent hours studying the preliminary drafts of the text and the problems, and have provided invaluable feedback on how the material could be improved. We hope we have responded to their suggestions effectively. Finally, we appreciate the long hours spent by our typists, especially Dolores A. Donohoo, who devoted many evenings and weekends to preparing several drafts of the manuscript.

While we recognize the important contributions made by so many others, we also realize that we bear the responsibility for any shortcomings contained in this text, and we hope that there are few. May you thoroughly enjoy your study of internal auditing, and may it be an exciting, profitable adventure.

Richard L. Ratliff  
Wanda A. Wallace  
James K. Loebbecke  
William G. McFarland



# About the Authors

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**James K. Loebbecke, CPA**, is professor of accounting at the University of Utah Graduate School of Business and a former audit partner with Touche Ross & Co. He has served on the Auditing Standards Board of the American Institute of Certified Public Accountants and is a member of the American Accounting Association. He is the recipient of the 1987 Wildman Medal and the University of Utah School of Accounting's 1985–1986 Outstanding Teaching Award. Mr. Loebbecke is the co-author of several books and monographs on accounting- and auditing-related subjects and is a frequent contributor to major publications in the field.

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