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# INTERNAL AUDITING

Andrew D Chambers

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# Internal Auditing

Theory and Practice

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PITMAN BOOKS LIMITED  
39 Parker Street, London WC2B 5PB

*Associated Companies*  
Pitman Publishing Pty Ltd, Melbourne  
Pitman Publishing New Zealand Ltd, Wellington

©Andrew D Chambers 1981

First published in Great Britain 1981

British Library Cataloguing in Publication Data

Chambers, A.

Internal auditing.

1. Auditing, Internal

I. Title

657'.458      HF5668.25

ISBN 0-273-01632-6

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Text set in 10/12 pt Linotron 202 Plantin, printed and bound in Great Britain at The Pitman Press, Bath

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# Foreword

I feel very pleased with the author's request to write the foreword to his book *Internal Auditing—Theory and Practice*. As the Leverhulme Senior Research Fellow in Internal Auditing at the City University Business School (CUBS) Andrew Chambers, from 1974 onwards, did much original, theoretical as well as practical research into internal auditing. This resulted, particularly from 1976, in a considerable number of very interesting reports and articles published in various journals of repute.

For nearly ten years Andrew Chambers has built up a wide teaching experience at CUBS where, in the MSc programmes in Administrative Sciences and in Finance, he has been in charge of three different major courses: 'Management Information Systems and the Computer', 'Financial Management' and 'Internal Auditing'. It is noteworthy that at CUBS he developed the Internal Auditing Major from scratch—thus introducing this discipline for the first time into a UK university. In addition Andrew Chambers has been teaching on undergraduate and post-experience courses held at CUBS. Since 1978 he has been Senior Lecturer in Audit and Management Control at that University. Moreover, he has given a great many lectures for professional and educational bodies and at staff conferences organized by companies and institutions in and outside the UK.

His lectures impress his audiences not only by their perfect mastery of the subjects but also by the clarity of presentation—in other words by the 'professional' way he succeeds in guiding through highly technical and difficult problems. The reader of this book will find the same didactical skills, together with a very personal approach to many subjects based upon the author's lengthy, extensive and intensive research in this field.

The results of his work enable him to focus upon aspects hitherto not so extensively covered in current books on internal auditing. Topics that are dealt with in this book in considerable depth include:

- the behavioural aspects of internal auditing
- risk management and internal auditing
- internal auditing as a profession

In addition Andrew Chambers comes forward with stimulating and challenging thoughts on a number of subjects; to mention only a few:

- his questioning of the internal auditor's claim to be a specialist in internal control,
- his discussion of participative auditing where, controversially, the internal auditor involves himself with the auditee in the implementation of his audit recommendations,
- his thesis that internal auditing should be taught as a special subject in a university curriculum.

It is not difficult to foretell that his points of view in these areas will be challenged by many internal auditors.

The very merits of this book lie in the new light the author sheds on aspects of internal auditing and in the challenging positions he takes on many issues.

I can strongly recommend this book to practitioners as well as to students in internal auditing who will find most valuable ideas for practice and further study.

R. Vanderheiden  
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*Leuven (Belgium)*

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# Preface

Much has been written on internal auditing. Just a small selection is cited in the Select Bibliography to this book. There are not, however, very many current textbooks on internal auditing. Practising internal auditors as well as teachers and researchers often lament the scarcity of thoughtful, conceptual material which they can use themselves and commend to their staff or students. It is hoped that this book will, within one volume, go some way to meeting this need.

Throughout, I have kept the interests of the practising internal auditor in mind and have tried to pack this book with practical advice to assist him to understand and to do his job better. Of course it is for those who use this book to decide whether I have succeeded. In writing this book I have also had the teacher of internal auditing in mind as well as his student: I hope they will both find a critical, conceptual treatment of issues of value to them. The discussion topics at the end of each chapter should give them opportunity to continue the debate: many of these will also be suitable as coursework topics or examination questions.

I acknowledge my immeasurable debt to those who have taught me what I know about internal auditing. Perhaps most of all I have learnt from so many friends in the Institute of Internal Auditors who have been so liberal in what they have passed on to me. I am particularly conscious of my debt to E. Dalton, C. L. Duly, Miss M. E. G. Graham, Dr G. Hibbert, H. J. M. Izzard, T. J. Nichols, A. J. O'Byrne, J. T. Reeve, R. L. Richmond, L. B. Sawyer, B. W. Schwarz, N. A. Smith, G. Ward and Professor R. Vanderheiden. Among the companies who have been a help to me are General Motors, the British Petroleum Company, Shell International Petroleum Company, Unilever and, of course, my publisher Pitmans. I trust I will be forgiven for any omissions I have made. Throughout the text I have endeavoured to reference my material to all the sources I have drawn from and, where appropriate, to obtain permission to use their work. If I have failed it is through oversight and I offer my sincere apologies.

I am particularly grateful to the Institute of Internal Auditors for permission to reprint their *Standards* and other *Statements*—upon which I realize so much of my own thoughts and so much of this book have been modelled.

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# **Part 1 An Overview of Internal Auditing**



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# 1 Internal Auditing: Increasing Responsibilities and Authority

## Summary

In this chapter we attempt to predict the future for internal auditing if current discernible trends as well as current policies and aspirations of interested parties are maintained; or, to use a nautical analogy, if the wind as well as wheel stay steady. Nothing is ever so simple. For internal auditing there will doubtless be winds of change, some of which are perhaps impossible to predict. On the whole, in the past, these have been fair winds for internal auditing. While internal auditing has sometimes become almost becalmed, it is likely in the future that there will be rather more storms to be weathered as progress is made more rapidly. A few touches on the tiller from those who steer the profession of internal auditing may, consciously or unconsciously, alter the course for the better—or for the worse. So there are several reasons why the forecasts in this chapter may never materialize, but at least this is an attempt to chart where internal auditing is currently heading. Here we introduce many of the concepts which are discussed in more depth elsewhere in the book.

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‘Most persons have no concept of the functions of internal auditing. Many think of it as identical with auditing performed by public accountants, with this exception that it is performed by an organization’s own employees. It is true that in many companies, internal auditing does answer this description. But in other corporations, internal auditing goes far beyond the mere verification of records and transactions. In such corporations, which I like to think of as being the most modern, the internal auditor performs three major functions:

- (1) he acts as an arm of management;
- (2) he rounds out and perfects the system of internal control;
- (3) he directly participates in the verification of financial statements.

*It is as an arm of management that internal auditing has its most brilliant future’.<sup>1</sup>*

<sup>1</sup> Thurston, J. B.: ‘1941—Modern Internal Auditing has Just Been Born’, speech of first president of the Institute of Internal Auditors at their inaugural meeting (1941). Reprinted in *The Internal Auditor* (Summer 1966).

### Professionalism

A development is good for internal auditing if it is good for those whom internal auditing serves. The trend towards professionalization for internal auditing is only legitimately based on the ideal of improving the quality of service. 'The service ideal is the pivot around which the moral claim to professional status revolves.'<sup>2</sup> Aggrandizement for the occupational group is insufficient to sustain a claim to professional status which will fail unless the nature and standard of the service requires the development of professional attributes by the occupational group.

Many of the developments in internal auditing which are outlined here may be seen as developments in an overall process of professionalization. It is necessary to introduce the concept of professionalization at this stage as it provides the key to understanding the evolution of internal auditing. It must be stated that there is not universal approval of the notion that internal auditing is, or should become, a profession. Doubts are most commonly expressed by the client group: management frequently sees no advantage in any separation of internal auditing from management in general. This does not necessarily disqualify internal auditing from becoming a profession: history has shown that client groups are poor judges of whether professional status is required for an occupational group in order that it can render a more effective service; it has tended to be the occupational group itself, rather than the client or society in general, that has forced the pace in the professionalization process. Internal auditing is no exception. We shall see, also, that the composition of the client group whom internal auditing is seeking to serve may be changing.

### Body of Knowledge

Wilensky summed up the distinctive attributes of a profession as being *autonomous expertise* and *the service ideal*. Greenwood<sup>3</sup> had broken these down into more detail, and it is his structure which we here apply to internal auditing. He postulated that all professions have a *systematic body of knowledge*. For internal auditing this has been defined by Gobeil,<sup>4</sup> though his ten pages are sparse compared to the equivalent attempts of the accounting profession.<sup>5,6</sup>

2 Wilensky, H.: 'The Professionalization of Everyone', *American Journal of Sociology*, vol. 7, no. 2, pp. 137-58 (September 1966).

3 Greenwood, E.: 'Attributes of a Profession', *Social Work*, pp. 45-55 (July 1957); reprinted as 'The Elements of Professionalization', *Professionalization*, edited by H. Vollmer and D. Mills. New Jersey, Prentice-Hall (1957).

4 Gobeil, R. E.: 'The Common Body of Knowledge for Internal Auditors', *The Internal Auditor*, vol. 29, no. 6, pp. 20-9 (Nov./Dec. 1972).

5 Roy and MacNeill: *Horizons for a Profession: the Common Body of Knowledge for Certified Public Accountants*, 332 pp. AICPA (1967).

6 Solomons, D. and T. M. Berridge: *Prospectus for a Profession*, 240 pp. Advisory Board of Accountancy Education, Gee & Co. (1974).

## Recognition

Second, a profession has *authority recognized by the client or user*: we shall see that increasing recognition is being given to internal auditors by management, external auditors and others. The internal audit *Standards* state that 'The members of the organization assisted by internal auditing include those in management and the board of directors. . . . The charter for the internal auditing department . . . should . . . specify the unrestricted scope of its work. . . . Compliance with the concepts enunciated by these *Standards* is essential before the responsibilities of internal auditors can be met.'<sup>7</sup>

## Monopoly?

Then, a fully-fledged profession enjoys the *sanction of the community* often evidenced in protective legislation. This is not well developed for internal auditing but the trend is favourable. For instance, in the United Kingdom, internal audit is now required by law in local government<sup>8</sup> and their statutory auditor is charged with directing his attention to the system of internal control *including the adequacy of internal audit*<sup>9</sup> (italics ours). It has also been suggested that all listed companies should be required to maintain an internal audit team, whereas at present only approximately half of these companies have an internal audit department. It is arguable that building societies are also required to maintain a satisfactory internal audit.<sup>10</sup> More generally, there is a striking development in awareness by the public of the desirability for effective control and audit within organizations, and the development of audit committees is part of this process.

## Self-regulation

Professions have *regulative codes of ethics* and this is true of internal auditing;<sup>11</sup> more recently, *Standards for the Professional Practice of Internal*

7 The Institute of Internal Auditors: *Standards for the Professional Practice of Internal Auditing*, in the Introduction (1978). The earlier exposure draft (September 1977) put it more concisely for our purposes: 'the *Standards* . . . should be accepted and met by the organization before it can obtain the benefits of professional internal auditing.'

8 The Local Government Act (1972): HMSO, see especially Statutory Instrument No. 1169 of The Department of the Environment: 'Local Government, England & Wales: The Accounts and Audit Regulations' (D. of E. 18241). See also correspondence in *Public Finance and Accountancy* (May 1979) pointing out that such an internal audit department need not be restricted to accounting and financial control. This correspondence was in response to the *Statement on Internal Audit Independence* by The Chartered Institute of Finance and Accountancy, *Journal of Public Finance & Accountancy* (February 1979).

9 The Department of the Environment: *Local Government Act 1972: Audit Provisions*. Circular 79/73 (1973).

10 The Building Societies Act (1962): HMSO (see especially paragraphs 76.1 and 79).

11 The Institute of Internal Auditors: *Code of Ethics* (1968).



*Auditing*<sup>12</sup> have been issued. They state that 'the internal auditor is to exercise *due professional care*' and outline what this amounts to. In addition to providing a code of practice for internal auditors, these *Standards* are also intended to impart an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, society, legislative bodies and related professional organizations. In other words, they are *Standards* of best practice as perceived by the world's leading internal auditors: as actual practice tends to lag behind standards they are, for many, a good guide to the future of internal auditing.

### An Evolving Client

In one potentially important respect, these *Standards* appear to seek to modify the recipient of the internal audit service and, if this adaptation is successfully achieved, it opens the door to a further enhancement of the professional status of internal auditing. A similar attempt was successfully made once before, and it can be argued that on both occasions the internal auditing profession has been simply responding to the developing requirements of the times. The first time this was done was in the 1940s. The quotation at the start of this chapter refers to internal auditing as *an arm of management*. This emphasis has certainly served internal auditing well and it has also been encapsulated in such slogans as *the eyes and ears of management* and *aid to management*. This crystallized the change of emphasis of internal auditing from an activity which checked for detailed *compliance* with laid-down accounting procedures on behalf of a senior accountant, to an activity which aided management to achieve *efficiency and effectiveness in all its operations*.

In this book, auditing terms are used as follows:

- Compliance auditing: determining whether actions have been in accordance with internal controls and procedures and with applicable external laws, regulations and practices.
- Efficiency auditing: determining whether resources (personnel, property etc.) are being utilized as optimally as is practical (the ratio of inputs to outputs).
- Effectiveness auditing: determining whether resources are being used to proper effect (the relationship of outputs to the desired goals of the enterprise).
- Operational auditing: the audit of operations outside the financial and accounting areas (such as personnel, distribution, production).

<sup>12</sup> IIA (1978): op. cit.