Second Edition

# The essential guide to internal auditing

K H Spencer Pickett

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| AC | Audit Committee |
| ACCA | Chartered Association of Certified Accountants |
| AICPA | American Institute of Certified Public Accountants |
| CAE | Chief Audit Executive |
| CBOK | Common Body of Knowledge |
| CEO | Chief Executive Officer |
| CFO | Chief Finance Officer |
| CG | Corporate Governance |
| CICA | Canadian Institute of Chartered Accountants |
| CIMA | Chartered Institute of Management Accountants |
| CIO | Chief Information Officer |
| COSO | Committee of Sponsoring Organizations of the Treadway Commission |
| CPA | Certified Public Accountant |
| CPD | Continuing Professional Development |
| CPE | Continuing Professional Education |
| CRO | Chief Risk Officer |
| CRSA | Control Risk Self-Assessment |
| CRSA | Control and Risk Self-Assessment |
| CSA | Control Self-Assessment |
| DF | Director of Finance |
| DP | Data Protection |
| EA | External Audit |
| ERM | Enterprise Risk Management |
| FCO | Foreign and Commonwealth Office |
| FSA | Financial Services Authority |
| GAAP | Generally Accepted Accounting Policies |
| GAIN | Global Audit Information Network |
| GAO | Government Accountability Office |
| GRC | Governance, Risk and Control |
| HM | Her Majesty's |
| HR | Human Resource |
| HRM | Human Resource Management |
| IA | Internal Audit |
| IC | Input Control |
| ICAEW | Institute of Chartered Accountants in England and Wales |
| ICE | Internal Control Evaluation |
| ICQ | Internal Control Questionnaire |
| IIA | Institute of Internal Auditors |
| IPPF | International Professional Practices Framework |

| | |
|---|---|
| IRC | INFOSEC Research Council |
| IS | Information Systems |
| ISO | International Standards Organization |
| IT | Information Technology |
| KPIs | Key Performance Indicators |
| KRCM | Key Risk and Control Matrix |
| MIS | Management Information System |
| MUS | Monetary Unit Sampling |
| NAO | National Audit Office |
| NED | Non-Executive Director |
| NYSE | New York Stock Exchange |
| OECD | Organization for Economic Cooperation and Development |
| PAC | Public Accounts Committee |
| PC | Personal Computer |
| PESTL | Political, Economical, Social, Technical and Legal |
| PPF | Professional Practices Framework |
| PSR | Preliminary Survey Report |
| PwC | PricewaterhouseCoopers |
| QA | Quality Assurance |
| RaCE | Risk-Assessed Control Evaluation |
| RBSA | Risk-Based Systems Auditing |
| SD | Systems Development |
| SD | Standard Deviation |
| SEC | Securities and Exchange Commission |
| SEC | Stock Exchange Commission |
| SIC | Statement on Internal Control |
| SWOT | Strengths, Weaknesses, Opportunities and Threats |
| US | United States of America |
| USA | United States of America |
| VFM | Value for Money |

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## Chapter 1

# INTRODUCTION

### Introduction

The 1000 page *Internal Auditing Handbook 3rd Edition* contains a comprehensive account of the role, responsibilities and work of the internal audit profession and this new book is a streamlined text from the same author that draws heavily from the main *Handbook.* The second edition of *The Essential Guide to Internal Auditing* reflects the significant changes in the field of internal auditing over the last few years. Since the last edition there have been many developments that impact the very heart of the audit role. There really are 'new look' internal auditors who carry the weight of a heightened expectation from society on their shoulders. Auditors no longer spend their time looking down at detailed working schedules in cramped offices before preparing a comprehensive report on low-level problems that they have found for junior operational managers. They now spend much more time presenting 'big picture' assurances to executive boards after having considered the really high-level risks that need to be managed properly. Moreover, the internal auditor also works with and alongside busy managers to help them understand the task of identifying and managing risks to their operations. At the same time the internal auditor has to retain a degree of independence so as to ensure the all-important professional scepticism that is essential to the audit role. The auditor's report to the board via the Audit Committee must have a resilience and dependability that is unquestionable and the audit product must add value to the employing organization. These new themes have put the internal auditor at the forefront of business, commerce and public sector entities as one of the cornerstones of corporate governance – and the new *The Essential Guide to Internal Auditing* has been updated to take this on board. The second edition of *The Essential Guide* contains much of the material that formed the basis of the first edition and has been expanded in the following manner:

1. The new edition has been updated to reflect the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing that were released during 2009.
2. Each chapter has a new section on new developments to reflect changes that have occurred since the first edition was published.
3. There is a new worked example of auditing the risk management process contained in the appendices.

Change is now a constant and we have tried not to focus too much on specific events such as the 2007/08 banking failures/Credit Crunch, the resulting recession and isolated incidents such as the Madoff fraud or the BP oil leaks in the Gulf Coast, since it is the principles of internal auditing that remain constant, regardless of the latest scandal to impact the economy. Please take a look at the Institute of Internal Auditors' web site at www.theiia.org to keep up to date with new developments and the latest corporate scandals.

The first edition of *The Essential Guide* described internal auditing as a growing quasi-profession. The quantum leap that occurred between the old and new millennium is that internal auditing has now achieved the important status of being a full-blown profession, led by a chief audit executive.

Note that the term 'chief audit executive' (CAE) is used throughout the book and this person is described by the Institute of Internal Auditors (IIA):

> The chief audit executive is a senior position within the organization responsible for internal audit activities. Normally, this would be the internal audit director. In the case where internal audit activities are obtained from external service providers, the chief audit executive is the person responsible for overseeing the service contract and the overall quality assurance of these activities, reporting to senior management and the board regarding internal audit activities, and follow-up of engagement results. The term also includes titles such as general auditor, head of internal audit, chief internal auditor, and inspector general.

With the growing influence of internal auditing comes the need to ensure expectations of a professional service are fully understood and fully met. Regulators around the world have now recognized the real impact a fully professional internal audit function can make in promoting good governance. However, with greater recognition comes a greater responsibility to deliver the goods, which is why *The Essential Guide* has been prepared with the need for auditors to live up to this enhanced role kept fully in mind.

The areas that are included in this chapter are:

1.1 Reasoning behind the Book
1.2 The IIA Standards and Links to the Book
1.3 How to Navigate around the Book
1.4 *The Essential Guide* as a Development Tool
1.5 The Development of Internal Auditing
Summary and Conclusions

## 1.1 Reasoning behind the Book

The original *Essential Guide* focused on the practical aspects of performing the audit task. It contained basic material on managing, planning, performing and reporting the audit, recognizing the underlying need to get the job done well. The new edition has a different focus. Now we need first and foremost to understand the audit context and how we fit into the wider corporate governance agenda. It is only after having done this that we can go on to address the response to changing expectations. In fact, we could argue that we need to provide an appropriate response to the call for better and more effective governance of both private and public sector organizations, rather than think of the audit position as being more or less static. It is no longer possible to simply write about an audit plan, preparing the audit programme and how best to perform the audit task. To do justice to the wealth of material on internal auditing, we must acknowledge the impact of internal audit standards and the work of writers, thought leaders, academics and journalists.

The new context for internal auditing is set firmly within the corporate governance and risk management arena. The Institute of Internal Auditors' (IIA) definition of internal auditing was not changed when the standards were revised in January 2009 and remains as follows:

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

As a result, *The Essential Guide* has early 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 also chapters covering professional standards, audit approaches, managing internal audit, planning, performance and reporting audit work and specialist areas such as fraud and information system (IS) auditing. The final chapter attempts to peer into the future at some of the changes that may well be on the way. *The Essential Guide* rests firmly on the platform provided by the IIA's International Standards for the Professional Practice of Internal Auditing as part of the International Professional Practices Framework (IPPF). Internal auditing is a specialist career and it is important that we note the efforts of a professional body that is dedicated to this chosen field. Note that despite the recent changes in the field of internal auditing there is much of the first book that is retained in the new edition. Change means we build on what we, as internal auditors, have developed over the years rather than throw away anything that is more than a few years old. This is why much of the original material from the first edition has not been discarded – as the saying goes, it is important not to throw away the baby with the bath water. Note that all references to IIA definitions, code of ethics, IIA attribute and performance standards, practice advisories and practice guides relate to the International Professional Practices Framework (IPPF) prepared by the Institute of Internal Auditors in 2009.

## 1.2 The IIA Standards and Links to the Book

*The Essential Guide* addresses many aspects of internal auditing that are documented in the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing. Some years ago, the Institute of Internal Auditors (IIA) Executive Committee commissioned an international Steering Committee and Task Force to review the Professional Practices Framework (PPF), the IIA's guidance, structure and related processes. The Task Force's efforts were focused on reviewing the scope of the framework and increasing the transparency and flexibility of the guidance development, review and issuance processes. The results culminated in a new International Professional Practices Framework (IPPF) and a reengineered Professional Practices Council, the body that supports the IPPF. 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, Position Statements and Practice Guides and other reference material, they constitute a worldwide professional framework for internal auditing. The IIA's main Attribute and Performance Standards are listed below.

### *Attribute Standards*

***1000: Purpose, Authority, and Responsibility*** The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

***1100: Independence and Objectivity*** The internal audit activity must be independent and internal auditors must be objective in performing their work.

***1200: Proficiency and Due Professional Care*** Engagements must be performed with proficiency and due professional care.

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***1300: Quality Assurance and Improvement Program*** The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

### *Performance Standards*

***2000: Managing the Internal Audit Activity*** The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

***2100: Nature of Work*** The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

***2200: Engagement Planning*** Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing, and resource allocations.

***2300: Performing the Engagement*** Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.

***2400: Communicating Results*** Internal auditors must communicate the engagement results.

***2500: Monitoring Progress*** The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

***2600: Resolution of Senior Management's Acceptance of Risks*** When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must report the matter to the board for resolution.

## 1.3 How to Navigate around the Book

A brief synopsis of *The Essential Guide* will help the reader work through the material. Although most chapters contain 10 main sections, they are each of variable length:

### *Chapter 1 – Introduction*

This, the first chapter, deals with the content of *The Essential Guide* and lists the International Standards for the Professional Practice of Internal Auditing. It also covers the way *The Essential Guide* can be used as a development tool for internal audit staff. The way internal auditing has developed over the years is an important aspect of the chapter, whereby the progress of the profession is tracked in summary form from its roots to date. It is important to establish the role of internal audit at the start of the book in order to retain this focus throughout the next few chapters, which cover corporate perspectives. Note that the internal audit process appears in some detail from Chapter 5 onwards. Likewise our first encounter with the IPPF appears in this chapter, which will underpin the entire *Essential Guide*.

## *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. A main driver for 'getting things right' is the constant series of scandals that have appeared in developed (as well as developing) economies. The governance equation is quickly established and then profiles of some of the well-known scandals are used to demonstrate how fragile accountability frameworks can be. 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. Note that the chapter may be used by anyone interested in corporate governance as an introduction to the subject. The section on internal auditing is very brief and simply sets out the formal role and responsibilities, without going into too much detail. One topic that stands out in the chapter relates to audit committees, as many view this forum as the key to ensuring corporate responsibility and transparency. The corporate governance debate is ongoing and each new code refers to the need to start work on updates almost as soon as they are published. As such, it is never really possible to be up to date at publication and the reader is advised to keep an eye on new developments as and when they arise.

## *Chapter 3 – Managing Risk*

Many writers argue that we have entered 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 process as part of the response to threats and opportunities. The corporate aspiration to embed risk management into the way organizations work is discussed. The growing importance of control self-assessment has ensured this appears in *The Essential Guide*, although this topic is also featured in the chapter on audit approaches (Chapter 7). The chapter closes with an attempt to work through the audit role in risk management and turns to the published professional guidance to help clarify respective positions. There is a link from this chapter to risk-based planning in the later chapter on setting an audit strategy (Chapter 8). Throughout *The Essential Guide* we try to maintain a link between corporate governance, risk management and internal control as integrated concepts that impact the internal audit role.

## *Chapter 4 – Internal Controls*

Some argue that internal control is the 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. An auditor armed with a good control model is more convincing that one who sees controls only as isolated mechanisms. Chapter 4 takes the reader through the entire spectrum of control concepts from control models, procedures and the link to risk management. One key section concerns the fallacy of perfection, where gaps in control and the reality of imperfection are discussed. For most business ventures it is uncertainty that creates business opportunities and new thinking. With the advent of risk management this does not mean controls take a back seat; it just means controls need to add value to the business equation to be of any real use.

## *Chapter 5 – The Internal Audit Role*

This chapter moves into the front line of internal audit material. Having gone through the reasoning behind the audit role (governance, risk management and the need for sound controls), we can turn to the actual role. The basic building blocks of the audit charter, independence, ethics and so on are important aspects of *The Essential Guide*. Much of the material builds on the original first edition of *The Essential Guide* and is updated to reflect new dimensions of auditing. One key component is the section on audit competencies, which forms the balancing factor in the equation – 'the challenges' and 'meeting the challenges'.

## *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, while the main footing for *The Essential Guide* revolves around the IIA's IPPF. Moreover, quality is a theme that has run across business for many years. If there are quality systems in place for internal auditing, we are better able to manage the risk of poor performance. It would be ironic for internal audit reports to recommend better controls over operations that are reviewed when the audit team has no robust system in place that ensures it can live up to its own professional standards. Processes that seek to improve the internal audit product are covered in this chapter, including the important internal and external reviews that are suggested by auditing standards.

## *Chapter 7 – The Audit Approach*

The range and variety of audit services that fall under the guise of internal auditing have already been mentioned. A lot depends on the adopted approach and, rather than simply fall into one approach, it is much better to assess the possible positions armed with a knowledge of what is out there. Once we know what services we will be providing, we can think about a suitable structure for the audit shop. There is a note on control risk self-assessment (CRSA) and consideration of how it is possible to integrate the CRSA technique with the audit process. Other specialist aspects of audit work involving fraud investigations and information systems auditing are also mentioned. The IPPF acknowledges the linked trend towards more consulting work by internal audit outfits and therefore the consulting approach has its own section in this chapter.

## *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 executive. In itself, this task depends on an intimate understanding of the corporate governance context, the audit role and competencies and challenge to add value to the business. The CAE needs to define a strategy, set standards, motivate staff and then measure what is done to have a half chance at delivering a successful audit service.

## *Chapter 9 – Audit Fieldwork*

Audit fieldwork covers the entire audit process from planning the assignment to reporting the results, while interviewing is seen as the primary means of obtaining information for the audit.

Various models are used throughout the chapter to explain the way risk-based auditing can be applied and there is coverage of planning, ascertaining, evaluating and reporting the audit assignment. The bridge between good working papers and audit findings and preparing the draft report is established using a key audit schedule as the pivotal document. Chapter 9 is quite involved and goes through the entire audit process in some detail.

### *Chapter 10 – Meeting the Challenge*

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

### *Appendix – Auditing the Risk Management Process: A Case Study*

The Appendix provides a case study on auditing the risk management process, which is provided in presentation format.

## 1.4 *The Essential Guide* as a Development Tool

All internal auditors need to be professionally competent and all internal audit shops need likewise to demonstrate that they add value to the task of enhancing risk management, control and governance processes. While a great deal of high-level work may be undertaken by the chief audit executive in terms of strategy, budgets and audit plans, the bottom line comes down to the performance of each and every individual auditor. It is this person who must carry the burden of heightened expectations where internal audit seeks a seat at the governance table. *The Essential Guide* is a resource that can be used to help support the internal auditor's constant drive to greater professionalism. It contains a basic minimum of knowledge that should be assimilated by competent internal auditors. *The Essential Guide* can also be used as an induction tool for new auditors who could work through each chapter and have a look at the case study in the Appendix.

## 1.5 The Development of Internal Auditing

Internal audit is now a fully developed profession. An individual employed in internal audit 10 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, 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'.[1]

### *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. One American text has detailed the history of internal audit:

> Prior to 1941, internal auditing was essentially a clerical function.... Because much of the record keeping at that time was performed manually, auditors were needed to check the accounting records after it was completed in order to locate errors... railroad companies are usually

> credited with being the first modern employers of internal auditors... and their duty was to visit the railroads' ticket agents and determine that all monies were properly accounted for. The old concept of internal auditing can be compared to a form of insurance; the major objective was to discover fraud....[2]

It is clear that the internal audit function has moved through a number of stages in its development which can be tracked as follows:

***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. Internal audit was based on a detailed programme of testing accounting data. Where this model predominates, there can be little real development in the professionalism of the internal audit function. It would be possible to disband internal audit by simply increasing the level of testing in the external auditor's work plan. Unfortunately there are still organizations whose main justification for resourcing an internal audit service is to reduce the external audit fee. 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 of these.[3]

***Internal check*** The testing role progressed to cover nonfinancial 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 checked by the auditor and deemed correct and above board. Internal control was seen as internal check and management was presented with audit reports listing the sometimes huge number of errors found by internal audit. The audit function typically consisted of a small team of auditors working under an assistant chief accountant. This actually encouraged management to neglect control systems on the grounds that errors would be picked up by the in-house auditors on the next visit. It locked the audit role tightly into the system of control, making it difficult to secure real independence. Moreover, most internal auditors assumed a 'Got-Ya' mentality, where their greatest achievements resided in the task of finding errors, abuse and/or neglect by managers and their staff. One writer has said:

> The old concept of internal auditing can be compared to a form of insurance; the major objective was to discover fraud more quickly than it could be discovered by the public accountant during an annual audit.[4]

**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 again presented with a list of errors and queries that were uncovered by the auditors. The auditors either worked in small teams based in accountancy or had dual posts where they had special audit duties in addition to their general accounting role. Audit consisted mainly of checking, with the probity visits tending to centre on cash income, stocks, purchases, petty cash, stamps, revenue contracts and other minor accounting functions. The main purpose behind these visits was linked to the view that the chief accountant needed to check on all remote sites to ensure that accounting procedures were complied with and that local books and records were correct. The audit was seen as an inspection routine on behalf of management. This militates against good controls, as the auditor is expected to be the main avenue for securing information on whether local office records were correct. Insecure head office management may then feel that their responsibility stops at issuing a batch of detailed procedures to local offices and nothing more. The auditors would then follow up these procedures without questioning why they were not working. The fundamental components of the control systems above local office level fell outside the scope of audit work, which was centred on low-level, detailed checking.

**Nonfinancial 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. The ability to define an audit's terms of reference stimulated the move towards greater professionalism, giving rise to the model of audit as a separate entity. Likewise, the ability to stand outside basic financial procedures allowed freedom to tackle more significant business problems. It was now possible to widen the scope of audit work and bring to bear a whole variety of disciplines and not just accounting experience.

**Chief auditors** Another thrust towards a high-profile, professional audit department was provided through employing chief internal auditors (or chief audit executives, CAEs) with high organizational status. They could meet with all levels of senior management and represent the audit function. This tended to coincide with the removal of audit from the finance function. The audit department as a separate high-profile entity encourages career auditors, able to develop within the function. This is as well as employing people who are able to use this audit experience as part of their managerial career development. The current position in many large organizations establishes a firm framework from which the audit function may continue to develop the professional status that is the mark of an accepted discipline. When assessing risk for the audit plan one asks what is crucial to the organization before embarking on a series of planned audits that in the past may have had little relevance to top management. Professionalism is embodied in the ability to deal with important issues that have a major impact on success.

**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, nonexecutive directors and senior management also provides an avenue for high-level audit work able to tackle the most sensitive corporate issues. This is far removed from the early role of checking the stock and petty cash. Internal audit was now poised to enter all key parts of an organization. An important development in the US occurred when the Treadway Commission argued that listed companies should have an audit

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