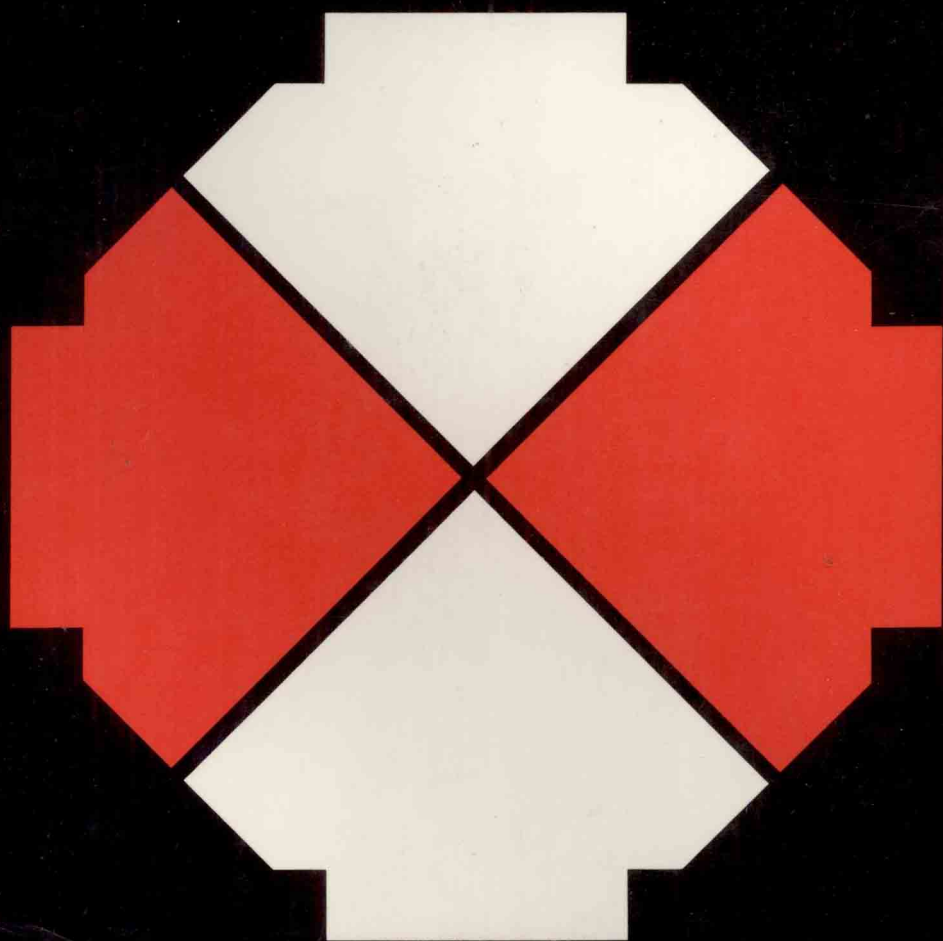


**J. S. R. VENABLES
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INTERNAL AUDIT

Second edition



Butterworths

INTERNAL AUDIT

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Preface

The need for a professional internal audit function emerged with the growth in size and complexity of organisations in both the private and public sector. There was a need to reassure accountable managers that complex fabrics of management obligations were being properly discharged and also to make a positive contribution to the achievement of the organisational objectives. Whilst identifying and evaluating opportunities and risks the internal auditor should also stimulate change leading to enhanced operational performance.

Very few comprehensive textbooks have been written on this subject and this book, which is the result of much research gleaned from many sources, concentrates the thoughts of many into one readable text, a text which has regard to practitioners and students alike. For the practitioner it offers guidance on developing the practical application of internal audit techniques. For the student it is designed to provide an authentic textbook encompassing the examination syllabuses of CIMA, CIPFA, IIA and AAT, but without sacrificing readability and with added enlightenment from diagrams and practical examples. The external auditor will find the book helpful in appraising internal audit work and the non-financial manager will appreciate the concept of using internal audit as a positive management service so banishing the negative image which in the past many have perceived as its main characteristic. Its potential to contribute constructively towards the achievement of corporate objectives is of particular interest to senior management who will find this book very helpful when defining a corporate internal audit policy.

Whilst the book covers all general internal auditing topics, examining a selection of specialist audits, particular attention is paid to the pursuit of improved operational performance and reassurance to management about the conduct of its operations.

The text of this second edition has been updated throughout and rearranged to give due emphasis to the most recent legislation and developments affecting the practice of internal auditing. The impact of significant developments in computer technology bringing a wide range of new opportunities and new risks is one of these developments which is addressed in detail in the chapters on information systems and computer security. A chapter has been added on corporate audit which examines the scope for internal audit to contribute to effectiveness and efficiency in the corporate management of an organisation. The chapter in which the role of internal audit is analysed has been fully revised to take account of the latest ideas on standards and guidelines for the practice of internal auditing.

Julian Venables
Ken Impey

April 1988

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Professional bodies

Chartered Association of Certified Accountants (*CACA*)
Chartered Institute of Management Accountants (*CIMA*)
Chartered Institute of Public Finance and Accountancy (*CIPFA*)
Institute of Chartered Accountants in England and Wales (*ICAEW*)
Institute of Internal Auditors—United Kingdom (*IIA-UK*)

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Journals

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CHAPTER 1 Introduction

Objectives	To introduce the positive contribution that internal audit can make to the management of the organisation
Content	Introduction; an agent for change; assisting management to fulfil obligations; an increasingly diverse role
Summary	Internal audit provides a supporting service to management which is independent of operational responsibilities and is used to provide objective analyses, counsel and recommendations concerning activities appraised, leading to enhanced efficiency and effectiveness

1.0 INTRODUCTION

The auditor is ‘a watchdog not a bloodhound’. This celebrated quotation from auditing case law is as pertinent to internal auditors as to statutory auditors. Nevertheless an image of the internal auditor as a bloodhound persists. It portrays the auditor unnecessarily raking over the past and pouncing on every minor mistake to uncover it as a serious misdemeanour. As with all stereotyping there may be a grain of truth and it is unfortunate that the image persists largely through the auditor’s backwardness at public relations.

It has to be a false image: it implies a presumption of wrong-doing, even of fraud; a suggestion that those whose work is to be subjected to audit examination are assumed to be guilty until proven otherwise.

Internal audit is a service to management. It is a function which management will have chosen to establish as part of the process of monitoring performance to help achieve the operational targets and plans adopted. The bloodhound image is not compatible with the management service concept: it conflicts with the basic philosophy of team management where motivation is based upon trust and responsibility. As a management service the function has to be recognised as an integral part of the management structure and part of the fabric of trust.

The role of the internal auditor has moved on from just checking that duties are being performed in compliance with instructions, although this remains a cornerstone for the work. It is now concerned with analysing the ability of the organisation to react to changing circumstances and with providing impartial advice to senior management on all aspects of policy implementation. It is at once a protective role, providing positive reassurance to all levels of management, and an activating role, contributing to improvements in

2 Introduction

operational performance: the watchdog has become a guide dog. The breadth and depth of this role means that it requires definition by senior management to fulfil given objectives in the context of each particular organisation.

Nor is this role restricted to the examination of financial systems. Finance may be regarded as a common factor binding the range of different functions which are essential to each particular activity into a single cohesive organisation, providing channels of communication and a means of measuring performance. The disciplines essential for effective financial control can also often be applied to non-financial operations in the pursuit of improved efficiency and effectiveness.

Throughout this book emphasis has been placed on the positive role that internal auditors have to play in identifying opportunities and risks and in giving reassurance to management that a complex fabric of management objectives is being fulfilled.

The internal audit function must be separate from all other management functions to preserve the element of independence necessary for making impartial and objective judgments. Internal auditors must identify totally with the objectives of the managements they serve but they should have no authority to change anything; their role is to observe and recommend. It is nevertheless a responsible role and the responsibility can be onerous. Some internal audit recommendations may have far reaching implications. The internal auditor needs to appraise potential opportunities and risks and acknowledge a share of responsibility in contributing to the decision making process.

When accountable managers accept internal audit assurances and recommendations they are placing considerable confidence in the auditor's judgement. There has to be a sound basis for such confidence. The internal auditor must not only have competence in the audit skills of penetrating observation, meaningful analysis and rational judgment, he must also demonstrate perceptive understanding of the operations and the management philosophy by offering sound recommendations which are also feasible.

2.0 AGENT FOR CHANGE

Internal audit is a management function.

Management is about motivating, organising and leading a team of people so that their collective activities achieve a defined corporate objective.

The survival of every such organisation in a competitive world depends upon its ability to fulfil its objective efficiently.

This is valid whether success is measured in terms of profit, service to customers or service to the public.

Economies of scale result in organisations of ever increasing size and this increases the complexity of the management task.

This increase in complexity is compounded by an ever growing body of legislation designed to protect the rights of individuals against unfair use of the power inherent in large organisations. Consequently the freedom of such organisations to act is restricted by laws for protecting the environment, the consumer, the employee, the investor and so on.

In a large organisation management has to be devolved through a formal structure which identifies separate functions with responsibility for specific areas of the overall objectives. The complexity is further compounded as each area is sub-divided.

Day-to-day management is a continuous decision-making activity which must occur when and where the operations to be managed are taking place. In a large organisation this activity is inevitably fragmented but the means must be retained for ensuring that every management decision made is consistent with the corporate objective and contributes to its achievement.

Formal systems for operational procedures and effective communication are clearly essential and it is important that these systems are so designed for all functions to be contributing fully to corporate objectives.

It is equally important to ensure the formal procedures are being properly observed.

Organisations have to be dynamic to respond to changing environments. Objectives change, organisational structures change, people change, systems and procedures may have to be flexible to cope with these changes or to take advantage of opportunities as they occur. In the process of change important links may be lost or signalling markers may get eliminated. Drift may occur in the observance of procedures.

Internal audit is the management function which monitors the continuing validity of management control systems and effective compliance. In fulfilling this role the internal auditor has an excellent viewpoint from which to recognise opportunities for strengthening systems and procedures, for improving methods and for achieving greater efficiency all with the object of increasing the contribution each management sector can make towards achieving corporate objectives.

Throughout this book we have referred to the internal auditor's special position as an agent for change. All organisations must change to survive in a changing environment. Achieving change is one of the most demanding of management tasks. In a large organisation it will usually involve a reorientation of the attitudes of many individuals. It will demand the application of a considerable degree of management skill to influence them effectively in order to overcome inertia and maintain motivation in a new direction.

This challenge is not new and was probably never described better than by Nicollo Machiavelli in the sixteenth century:

'There is nothing more difficult to carry out, or more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order. This arises partly from the incredulity of mankind, who do not believe in anything new until they have had actual experience of it.'

The internal auditor who acknowledges this is most likely to contribute positively to the process of change.

3.0 SERVICE TO MANAGEMENT

The Companies Act 1985 imposes obligations on the directors of public companies. They are required in particular to make provision for proper stewardship and accountability to shareholders. Although different legislation applies to the public sector, there is a similar need for management stewardship of public funds and accountability at the same time demonstrating the achievement of value for money. In this context the following quote from the Report of the 100 Group of Chartered Accountants is most apt.

'It is generally recognised that the proper organisation, staffing and methodology of internal audit presents the Board with the best means of focussing on its obligation to ensure proper controls in the business; and in so far as the work overlaps with external audit it is further recognised that there are opportunities for reducing the cost of statutory work.'

Though attention is drawn to reducing the cost of statutory audit, internal audit should not be seen as a cheap substitute for external audit work. Internal auditors often have similar qualifications to external auditors but their endeavours should be devoted to the pursuit of management objectives rather than verifying management's account of its achievements. Mention has already been made of the emphasis on value for money in the public sector. Similarly, in commercial organisations internal audit has to look beyond financial reporting into the underlying operational activity.

4.0 INCREASINGLY DIVERSE ROLE

The complexities and diversification of modern organisations and hence management has led to a much broader role for internal audit. Initially internal auditing was mainly concerned with financial security; subsequently the scope of internal auditing has been progressively widened to include audit appraisal of all aspects of operational activity, with the objective of evaluating organisational efficiency and the effectiveness of its systems to achieve organisational goals.

A survey of internal auditing in the UK and Eire in 1985, conducted by the IIA found that:

'The main changes scheduled for internal audit departments in around half the organisations were:

- to expand the scope of EDP audits;
- to expand the general audit scope.

For a third of the organisations it was:

- to expand the scope of operational audits.'

The role of internal audit is supportive, in that the objective is to provide all levels of management with reassurance that the objectives of the organisation are being achieved and performance enhanced.

However, to meet this expanding role the survey found that attracting and recruiting suitably-qualified or experienced staff was the major problem faced by organisations. It is to address this problem that this edition places further emphasis on operational audit and those sections which deal with computerised systems have been updated. The supporting role is presented positively, by focusing on the appraisal of both operational and administrative activity from the management viewpoint.

We start by introducing the role and need for internal audit, and go on to examine the relationship with external auditors. We then describe the skills required to manage internal audit activity and to become a successful internal auditor. Various areas of internal audit activity are then addressed, including the evaluation of financial security, systems evaluation and operational audit. Finally the book deals with various specialised areas, such as computer systems security, public sector audit and fraud investigation. Throughout the book internal audit is presented as an effective tool of management. The role of

internal audit may be described as follows:

Internal audit is an independent appraisal function within an organisation for the review of systems of control and quality of performance as a service to management. It objectively examines, evaluates and reports upon the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.

It is to this end that this book is devoted.

Further reading

Survey of internal auditing in the UK and Eire (IIA-UK 1985).

Sawyer, L B *Practice of Modern Internal Auditing.*

CHAPTER 2 The role of internal audit

Objectives	To describe the background and theory supporting the role of internal auditing
Contents	Definitions; the need for internal audit; the authority given to internal audit; audit theory and postulates; independence; evidence; materiality; accountability; due care; control; ethical conduct; professional standards
Summary	Theories and concepts are needed by professions to form a basis from which practice may develop in a consistent manner. Standards are discussed within the profession before being agreed as 'best practice'

1.0 INTRODUCTION

In both the USA and Canada the need for internal auditors has long been recognised. Indeed the Foreign Corrupt Practices Act 1977 (USA), whereby management have a statutory responsibility to maintain adequate internal control systems, further strengthens the need for internal audit. However, in the UK internal audit has in many ways been the 'Cinderella' of the auditing profession, the limelight being stolen by the statutory auditor. With this in mind it is useful to define and examine the need for internal auditing.

1.1 Some definitions

'Internal auditing is an independent appraisal activity established within an organization as a service to the organization. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls.' (*IIA Statement of Responsibilities of Internal Auditors* (1981))

'Internal audit is an independent appraisal within a department which operates as a service to management by measuring and evaluating the effectiveness of the internal control system.' (*Government Internal Audit Manual* (1983))

'Internal audit is an independent appraisal function within an organisation for the review of activities as a service to all levels of management. It is a control mechanism which measures, evaluates and reports upon the effectiveness of internal controls, financial and other, as a contribution to the efficient use of resources within an organisation.' (CIPFA 1979)

Internal audit is an independent appraisal function within an organisation for the review of systems of control and the quality of performance as a service to management. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.

From these definitions it can be seen that internal audit is perceived as being independent and as being part of the internal control system, whilst at the same time advising on methods of improving organisational performance. However, the overriding objective is to provide management with reassurance about the efficiency and effectiveness of operations that lead to the achievement of the goals of the organisation.

To expand upon these definitions, internal audit acts as a control mechanism of senior management to:

- 1 Ensure adequate internal control.
- 2 Review the reliability of records.
- 3 Enforce management decisions.
- 4 Undertake statutory duties where they exist.
- 5 Detect and prevent fraud.
- 6 Undertake 'value for money' exercises.
- 7 Undertake assignments as directed by senior management, eg implement external audit requirements.
- 8 Monitor the reporting procedures.

Thus, internal audit acts as the agent of senior management. Indeed, Professor W J M Mackenzie, in the foreword to *The Accountability and Audit of Governments*, concisely states, 'without audit, no accountability; without accountability, no control; and if there is no control, where is the seat of power?' (E L Normanton *The Accountability and Audit of Governments*).

2.0 WHY IS THERE A NEED FOR INTERNAL AUDIT?

2.1 Prevention and detection of error

Items 1, 2, 3 and 4 above may be broadly defined as regularity audits, ie the enforcement of the rules of the organisation. Error may be caused by deviation from such rules due to the failing of established checks. There is a need to detect errors and to take measures to prevent their recurrence. Managers are appointed for various reasons, of which financial or administrative ability may not be the prime asset required of them. On the other hand an internal auditor should be an expert on control procedures and able to offer sound advice to ensure that adequate internal checks are provided and that errors, where detected, are rectified promptly. At all times the manager should receive adequate information allowing the continuous monitoring of his area of responsibility. In many instances the internal auditor may be the only person able to offer independent and expert advice.

2.2 Prevention and detection of fraud and waste (items 5 and 6)

Imperfections in the moral character of those appointed to manage resources may result in dishonesty. To act as a deterrent to such lapses, an audit presence