MANUAL OF
INTERNAL
AUDIT
PRACTICE

EDITED BY
H. J. STEARN
and
K. W. IMPEY

The Institute of
Internal Auditors—UK

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& ADMINISTRATORS

Manual of Internal Audit Practice

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Foreword

The role of modern management continues to expand rapidly in response to technological development, changes in economic and social expectations, and the ever increasing complexity of organisations and their administration. These trends impose great reponsibilities upon directors and managers to maintain sound management control in order to safeguard the interests of the people who own the organisation, those whom it serves and, not least, those who work for it.

Effective internal audit is an invaluable tool of modern management. It provides positive assurance on the effectiveness and adequacy of control in a changing environment by identifying strengths and weaknesses and recommending any necessary remedial action. It also assists the achievement of management objectives by identifying opportunities and threats and offering practical ideas for addressing them.

As an authoritative guide to good internal audit practice we commend this manual to you. It encapsulates the knowledge and experience of many years of practical and successful internal auditing.

In expressing our appreciation to all contributors we endorse the ethos of the internal auditing profession: 'progress through sharing'.

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Preface

The aim of this manual is to provide an authoritative reference book covering all aspects of the practice of internal auditing, with particular emphasis on the practical application of the principles involved. These principles are generally well established and have been comprehensively defined in the statements of standards and guidance published by the Institute of Internal Auditors. Appropriate extracts from these statements are quoted throughout the text.

This is essentially a practical book based upon sound theoretical principles. It is written by an exceptionally well qualified team of contributors selected from experienced practitioners who are acknowledged leading experts in internal auditing and in management, both in private and public sector operations. Consequently, the text draws on a great wealth of relevant practical knowledge and experience. It presents internal auditing throughout as a key management tool: a control function used to monitor the quality and effectiveness of other controls. This is internal auditing perceived from the viewpoint of general management and in the context of contributing to the achievement of management goals.

The main thrust of the text is, first, to explain the philosophy of internal auditing and the techniques developed for its practice; it then demonstrates the relevance of these techniques by analysing the requirements for effective control in all the critical areas of general management and in a range of specialist management areas. The final three chapters

examine the role of internal auditing in the context of fraud, external audit and audit committees respectively.

The manual is intended primarily for use as a reference work, both by experienced internal auditing practitioners and trainees. It is likely to prove particularly helpful when tackling any internal audit assignment where unfamiliar circumstances occur or where fresh ideas are needed to resolve the problems encountered. It may not provide ready solutions to the problems: indeed, to have attempted to do so would, we believe, have been a disservice to the internal auditing profession. However, it will provide useful practical ideas for analysing the problems, so enabling the internal auditor to exercise sound, independent professional judgement which relates specifically to the circumstances found.

In adopting this approach we have also been concerned to make this manual a valuable guide for general managers who are in a position to benefit significantly from a sound understanding of internal auditing philosophy and practice. It should enable them to make best use of the function as a means for enhancing performance through improved control.

We are indebted to the contributors for the quality of the material provided, which we trust has lost none of its impact in the process of being welded into a single text.

Jock Stearn
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September 1990

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1 The nature of internal auditing

Introduction

Internal auditing is a developing profession which provides a service to assist managers to achieve corporate objectives. Consequently each internal audit unit must be designed to best serve its own organisation and will thus be unique with respect to its own environment. Nevertheless, as a profession, internal auditing must be identified with a common body of knowledge and recognised standards of practice.

Originally, internal auditing was primarily concerned with accounting accuracy and financial control but it subsequently developed to be equally applicable to appraising and evaluating the efficiency and effectiveness of all operational activity so that it now encompasses the entire field of management control.

Responsibilities

Internal auditing is an independent appraisal activity established within an organisation as a service to the organisation. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls.

The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost.

The scope of internal auditing encompasses the examination and evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of performance in carrying out assigned responsibilities.

(IIA–UK Statement of Responsibilities of Internal Auditing)

Analysis of the first paragraph of this statement enables us to clarify and crystallise our concept of what internal auditing now means.

Internal Makes clear that the work is undertaken by members or employees of the auditee organisation. As employees, internal auditors can be expected to have significant knowledge of the organisation's staff and systems and they should be attuned to a mutual culture and have an identity of interest in the objectives of the organisation.

Auditing Is defined in the Concise Oxford Dictionary as:

1. Official examination of accounts
2. Searching examination

Official examination of accounts is the role of external auditors appointed for such purposes. Searching examination of any or all activity of the auditee organisation is the function of the internal auditor.

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Independent   Addresses the relationship and attitude required of an individual appointed from within the auditee organisation to carry out searching examination as an internal auditor. It relies upon the organisational status and the personal integrity and courage of the internal auditor all of which must be supported by top management.

Whilst no employee can be absolutely independent of the organisation which is the paymaster, internal auditors must be totally independent of all specific activities which they are required to examine.

Appraisal   Is an estimate of value or quality. The internal auditor has the responsibility to interpret the facts revealed by searching examination and to make known their purport and significance. This requires the application of professional judgement based upon knowledge and experience.

Established   Signifies the legitimacy and authority of the internal auditing function as prescribed by the top management of the auditee organisation.

Service   Defines the primary function of internal auditing to support and assist the management of the auditee organisation to achieve the organisation's goals.

Organisation   Is the corporate body which has established the internal auditing function within its organisational structure. This body is described as the auditee organisation because its activities are then subject to examination by the internal auditing function, it is the recipient of the internal auditing service, and it is entitled to benefit from it.

Control   Is defined in the Shorter Oxford Dictionary as:

The act of checking and directing action

This is a critical element in the cycle of management processes: planning – directing – controlling – planning. Control involves monitoring and corrective action; it has a forward influence related to backward review. Internal audit is a critical control tool for management because it focuses on the effectiveness of other controls.

Examining and evaluating   Describe the internal auditing tasks of collecting, analysing, interpreting and documenting information in support of audit conclusions and recommendations.

Adequacy and effectiveness   Mean that internal auditors must satisfy themselves both about the need for the control procedures in place and that such procedures are being properly applied so that they operate satisfactorily. Control procedures should be subject to cost/benefit analysis in the same way as other operational activities.

Other controls   Refers to the operation of all the control devices which the auditee organisation has adopted. They include all those functions, systems and procedures which have been established for the primary purpose of assisting the management of the auditee organisation to fulfil plans and achieve objectives. Internal auditing is one such function and it contributes by examining and evaluating the adequacy and effectiveness of any or all of the other control devices.

Definitions

Internal check

All functional units employing a number of people who undertake relatively routine tasks should have internal checks built into their procedures as a means of checking the quantity and quality of work and preventing error. The essential nature of internal check is that as each task is completed by one employee or group of employees the work is scrutinised, checked and approved by another employee or group of employees before the next task on that work can start.

Internal checking is particularly associated with accounting work as a means of ensuring accuracy and preventing irregularities. It is however equally applicable to all operational procedures which involve employees completing routine tasks. It is essentially preventative, ensuring that routine procedures are adhered to and that lapses are identified so that they can be promptly rectified.

Similar automatic checking routines must be built into computerised information processing systems.

This is a critical requirement in system design providing vital protection against misuse of the computer's high-speed processing power and its potential to corrupt vital information very fast. The data must be fully checked and validated at each stage of processing before it can progress to the next stage.

Control

A control is any action taken by management to enhance the likelihood that established objectives and goals will be achieved. Management plans, organises and directs the performance of sufficient actions to provide reasonable assurance that the objectives and goals will be achieved. Thus, control is the result of proper planning, organising and directing by management.

(IIA–UK, Guideline 300.06)

The overall system of control is conceptual in nature. It is the integrated collection of controlled systems used by an organisation to achieve its objectives and goals.

(IIA–UK, Guideline 300.06.4)

Internal control

The variant 'internal control' came into general use to distinguish controls within an organisation from those existing externally to the organisation (such as laws). Since internal auditors operate within an organisation and, among other responsibilities evaluate management's response to external stimuli (such as laws), no such distinction between internal and external controls is necessary. Also, from the organisation's viewpoint internal controls are all activities which attempt to ensure the accomplishment of the organisation's objectives and goals. For the purpose of this statement, internal control is considered synonymous with control within the organisation.

(IIA–UK Guideline 300.06.3)

The primary objectives of internal control are to ensure:

.1 The reliability and integrity of information.
.2 Compliance with policies, plans, procedures, laws and regulations.
.3 The safeguarding of assets.
.4 The economical and efficient use of resources.
.5 The accomplishment of established objectives and goals for operations or programmes.

(IIA–UK Guideline 300.05)

Internal control will usually mean all measures taken by management in order that the organisation's policies, plans and procedures succeed. It requires the setting of objectives, targets and standards so that performance deviations can be monitored and corrective action taken. The establishment of economic, efficient and effective systems of internal control is the responsibility of the management of an organisation. Management may set up an internal audit unit to assist members of the organisation in the effective discharge of their responsibilities.

2 Managing the internal audit department

The nature of management

'Management' is a term used generally for the managing process at many different levels in an organisation. Managing is perhaps the most important kind of work that is carried out in any organised human activity. This chapter is concerned with the practice of managing the internal audit function and how this relates to other levels of management, within an organisation and externally with other groups.

The theory and principles of management have been well researched this century. Many see management as a science based on a set of rational laws; others see management as more a set of values and style than a theory. The practice is almost certainly a mixture of established law with changing values and style influenced by time and a wide spectrum of events, internal and external to the organisation. It is this mixture which makes the managing process so predictable and yet so varied in its practice.

The established law governing the managing process is based on a series of rational steps which include the following:

set objectives
direct the process
measure the results
review the objectives

In this chapter each of these steps will be examined as it relates to managing the internal audit function. Each is a key to the success of any process, in any organisation. Each is strongly influenced by values, style and organisation structure. Management never stands in isolation from an organisation's activities, nor indeed from changes in the environment whether social or technical. For the foreseeable future changes in values and style of the managing process will almost certainly continue to be influenced by the factors set out below.

Technology Increased information and the speed with which activities can be accomplished will accelerate.

World-wide operations International relationships, standards and regulations will increase.

Economic environment Results in home markets will react quickly across national boundaries. The drive for quality in both products and services will increase, forcing changes in organisations and operations.

Participation More open communication and participation by employees will be encouraged throughout organisations, prompted by improved education and a greater involvement by people in their situations within organisations.

Government influence Concurrent with an era of increased freedom for the individual there will continue to be increased regulation over the activities of organisations.

All of these changes will influence the development of management of the internal audit process. The remainder of this chapter will explore how these changes can be used to improve the service which internal auditing provides within organisations.

Independence

Achieving independence

Chambers, Selim and Vinten (1987) use the classical functional, administrative, task-oriented reporting lines to describe the responsibility relationships which can exist for an internal audit department. They provide examples of organisation structures using the services of an internal audit function and develop some general principles on methods of reporting.

John Child (1977) summarises organisation structure as a means for allocating responsibilities, producing a framework for operations and performance assessment and furnishing mechanisms to process information and assist decision making. The placing of the internal audit department in the organisation structure is therefore an important first step in managing the internal audit process. Each responsibility line added to the internal audit department enhances the independence of the function.
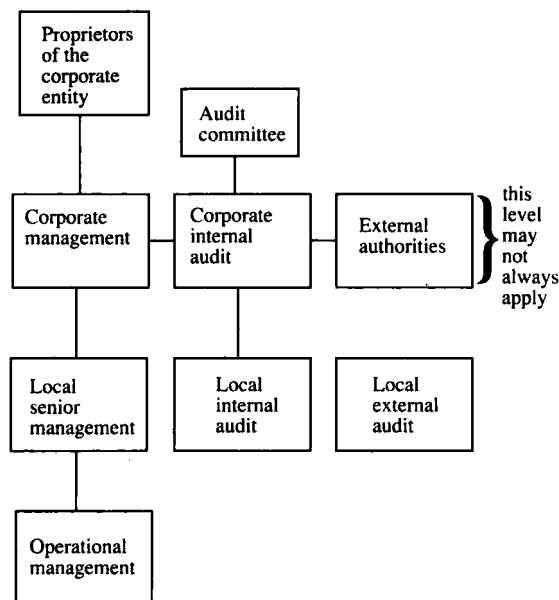

Figure 2.1   Organisation for audit independence

This can be seen more clearly by reference to Figure 2.1. The 'local' internal audit group may be the only internal audit function in the organisation or it may form part of a larger organisation structure with national and international levels of audit management.

Responsibility lines created by the organisation structure can be extremely complex and can serve various purposes. It is important that these are all understood by those managing the organisation and by the chief internal auditor. The structure of reporting does not necessarily require the internal audit function to report directly to the chief executive of an organisation. In many organisations the line is to a financial manager and this can achieve the required objective provided it is at a senior enough level. A suitable structure as shown in Figure 2.1 is designed to achieve the following objectives:

Relationships	Objectives
1. Local internal audit to:	Authority of position
Corporate management	Broad audit scope
Local senior managment	Adequate consideration of
Operational management	audit findings
	Appropriate action
Audit committee	
Corporate internal audit	
2. Local internal audit to:	Co-ordination of audit
Corporate internal audit	activities
External authorities	Development of common
	audit techniques
Local external audit	Risk analysis
	Joint audits
3. Local internal audit to:	Audit assignments
Operational management	Internal consultancy role: prevention rather than detection

The responsibility for achieving these objectives should be written into the charter for the internal audit function which will then give considerable strength to the independent role of the chief internal auditor. Specific reporting lines should be developed from the responsibility lines.

The IIA Standards and Guidelines for the Professional Practice of Internal Auditing place the responsibility for seeking approval and acceptance for the independence of the internal audit function on the chief internal auditor. In some organisations, responsibility for the independence of the internal audit function has been assigned to an audit committee. There may also be a legal foundation for independence in certain organisations. There is some evidence that increasing regulatory laws may strengthen the independence of the internal audit function and encourage changes in the reporting lines to management and to those external bodies interested in an organisation's operations.

The tasks, responsibilities, and goals of audit committees and internal auditing are closely intertwined in many ways. As the magnitude of corporate accountability issues increases, so does the significance of the relationship of the internal auditing function to the audit committee. The audit committee has a major responsibility in ensuring that the mechanisms for corporate accountability are in place and functioning. A sound, well-orchestrated, co-operative relationship with the internal auditing function is critical to this responsibility.

Wherever the internal auditing function is placed in the structure of the auditee organisation, and whatever influences there are, the chief internal auditor has a clear responsibility to ensure that independence is written into the internal audit charter and that sufficient responsibility lines exist to achieve this. An example of an internal audit charter is given in Appendix 1.

Organising the internal audit department

Having established the responsibilities of the internal audit function, the next management step is to direct the internal audit process by establishing the department's resources and organising these in the most effective way. Size of the department and the nature of the auditee organisation's operations will play a significant part in the extent of internal audit coverage. It is rare for the size of a department to be based on any formulae calculated using the financial resources of the auditee organisation or the number and variety of operations to be audited, although all of these factors will have some influence.

It is the responsibility of the chief internal auditor to establish staffing plans and financial budgets consistent with the internal audit charter and the goals of the auditee organisation. The following factors must be taken into consideration when establishing an organisational structure for the internal audit department:

1. Scope of audit coverage – functions – frequency of audit.
2. Responsibility relationships with other audit groups, e.g. external audit, other control units in the organisation.
3. Geographic area occupied by the auditee organisation.
4. Risks involved in operations of the auditee organisation.
5. Quality of internal audit staff.
6. Other non-audit responsibilities, e.g. training, control.

Few internal auditing textbooks provide guidance on the organisation of internal audit departments. Heeschen and Sawyer (1984) outline some typical organisational structures for corporate audit departments based on specialist and generalist staffing. The tendency is for small departments to be single units which are generalist in staffing and structure, and the larger departments to be a number of units, possibly spread over a geographic area with generalist and specialist internal audit staff. Small departments usually recruit only professionally qualified staff and large departments have more levels of staff skills and responsibilities, which will influence the organisational structure adopted.

For certain organisations, there are statutory requirements to maintain an effective internal audit function and this can influence the size of the audit group and its structure. In the United States, the Treadway Commission report on fraudulent financial reporting issued an exposure draft (April 1987) which recommended that:

public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.