Brink's Modern Internal Auditing

Sixth Edition

Robert R. Moeller

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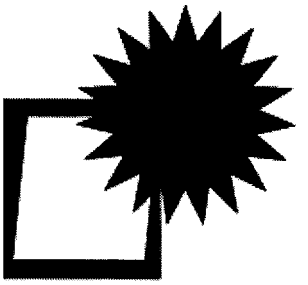

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To my best friend and wife,

Lois Moeller

About the Author

Robert R. Moeller has over 25 years experience in internal auditing, ranging from launching new internal audit functions in several companies providing internal audit consulting and serving as audit director for a *Fortune* 50 corporation.

Moeller has an MBA in finance from the University of Chicago and an undergraduate degree in engineering; he has accumulated a wide range of professional certifications including the CPA, CISA, PMP, and CISSP. He was appointed the national director of information systems auditing for the major public accounting firm of Grant Thornton. There he developed firmwide audit procedures and directly managed information systems audits, and assumed responsibility for their Chicago office information systems consulting practice.

In 1989, Moeller was recruited to build and organize the first corporate information systems audit function for Sears Roebuck, an organization that then consisted of AllState Insurance, Dean Witter, and Discover Card, as well as the Sears retail operations. He went on to become their audit director, initiating numerous new practices. He has been active professionally in both the Institute of Internal Auditors and the AICPA. He was president of the IIA's Chicago chapter, served on its International Advanced Technology Committee, and was chair of the AICPA's Computer Audit Subcommittee.

In 1996, Moeller launched his own corporation, Compliance and Control Systems Associates, Inc., and presented seminars on internal controls and corporate governance throughout the United States. He was then talking about Sarbanes-Oxley issues well before the Act. He has helped launch a new consulting practice for EMC Corporations, has worked as a consultant and project manager, specializing in the telecommunications industry, and managed a cellular telephone financial system project on a worldwide basis. More recently, he has led in a series of Sarbanes-Oxley Section 404 projects in manufacturing, finance, and other industries. He continues to stay well-connected with the overall profession of internal auditing.

Robert Moeller lives with his wife, Lois, in the Chicago area. They enjoy sailing on Lake Michigan in the summer, skiing in Colorado and Utah, and participating in Chicago's theatre, opera, and music scene.

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Preface

In 1941, the clouds of war—initiated by such dictators as Hitler, Mussolini, and Stalin—were surrounding much of the world. At the same time, Victor Z. Brink completed his New York University PhD thesis. While the "maximum leader" dictators were predicting one kind of violent revolution, Brink's PhD thesis outlined a much more benign revolution, a revolution in the way that internal auditors should perform their work. Prior to the 1940s, internal auditors were essentially in-house assistants to their company's public accounting firms, often performing little more than clerical financial auditing support duties for those external auditors. Brink's thesis argued that a much better role for internal auditors should be servants to management, not external auditor assistants.

Brink then went off to service in World War II, but not before the wheels were put in place to publish his thesis as a book for business leaders. Its title was *Modern Internal Auditing*. With the United States gearing up for total war and looking to better utilize every scarce resource, the first edition of *Modern Internal Auditing* (published by John Wiley & Sons in 1942) caused many managers to consider how they might better organize their internal audit functions. Brink's book strongly proposed that internal auditors could and should be much more significant members of an organization's management team. The *modern* internal auditor that Brink envisioned served management by going beyond routine accounting verification procedures and taking a broader approach of *supplying service to management* as part of his or her internal audit activities.

Brink returned from the war and became director of internal audit for the Ford Motor Company. He also worked with others, such as Brad Cadmus and Larry Sawyer, to build and better define this new profession called internal auditing. A final result of the work of Brink and others was the establishment of the Institute of Internal Auditors (IIA), now a major professional accounting organization, responsible for setting standards and providing guidance to the profession of internal auditing. Often, authors of significant and groundbreaking business books "go to sleep" after their first or second editions. However, Brink kept active in the profession, revising his original 1942 edition three times over the years, either by himself or in collaboration with others in later editions.

Although Brink introduced new concepts and technologies in the subsequent editions, he never lost his basic philosophy that internal auditing should provide a basic and essential *service to management* in the modern organization. Robert Moeller took general responsibility for the fifth edition of *Modern Internal Auditing* released in 1999, and had an opportunity to meet with Vic Brink and

discuss internal auditing concepts from the very early days leading to the development of that edition. Vic Brink was an impressive, interesting man, with an ongoing concern for the practice of internal auditing. This sixth edition preserves Brink's important concept of internal audit's responsibility to management but also introduces many of the changes and concepts that continue to make internal auditing exciting and important.

Each new edition of *Modern Internal Auditing* has focused on changes that were then affecting the profession of internal auditing. The fifth edition, for example, emphasized the growth of computers and information systems as a change that has very much impacted internal auditors over the last 50 to 60 years. At the time of the first edition of *Modern Internal Auditing*, the digital computer essentially did not exist and companies were just beginning to use 80- or 90-column punched-card tabulating equipment for some of their elementary statistical recordkeeping applications. There was no need to mention these machines in the first edition of this book because they were just not that important to businesses. Mainframe computers, behemoths that weighed tons and occupied major areas of floor space, were introduced in larger companies starting in the 1960s, but internal auditors initially were not concerned with them. This was the era in which audits were performed *around* the computer; that is, if a total had been generated by the computer and printed on some report, it was assumed to be correct because "the computer figured it out." Auditors were primarily concerned that the input controls were adequate. Internal auditors had little to do with these computer systems besides perhaps checking to see if the door to the computer room was locked or that candy and soft drinks were not being consumed in the computer room. The fifth edition tried to give some broad internal audit guidance in many information systems–related areas.

This sixth edition is released in the midst of a new era of concerns and responsibilities for internal auditors. The concerns regarding corporate governance, associated with the collapse of Enron Corporation, MCI, Adelphia, and others as well as the collapse of the then prominent public accounting firm, Arthur Andersen, led to the passage of the Sarbanes-Oxley Act (SOA) by the U.S. Congress in 2002. This legislation has a worldwide impact on organizations and both internal and external auditors. In many respects, SOA has given internal audit functions a level of "new respect" in the eyes of their corporate audit committees, management, the external auditors, and a much broader public.

This book has an overall objective to give the reader an overview of the many issues facing internal auditors today as well as areas of good internal audit practices. An example is the SOA Section 404 review, an internal controls document and testing process that has become a major concern for organization management today. Chapter 6, "Evaluating Internal Controls: Section 404 Assessments," provides internal audit guidance for these important SOA review requirements. In addition, an overall theme of the periodic editions has been to introduce and emphasize newer areas that should be of interest to internal auditors. The early editions of this book under Victor Brink described the operational approach to internal auditing, a major and important change from the compliance- and financial-related approaches of most internal auditors at that time. Similarly, the previous fifth edition by this author discussed such new areas of internal

audit interest as the COSO (Committee of Sponsoring Organizations) internal controls framework, the importance of ethics and codes of conduct, and auditing systems under development. These were not common topics of interest for internal auditors at that time, but were areas that were believed to be of interest for the modern internal auditor. Perhaps ahead of our time, the topics on COSO internal controls as well as ethics and codes of conduct are important elements of today's SOA-driven world.

This edition continues to follow this theme of introducing newer areas of internal control or management concern that should at least be of interest to today's modern internal auditor. An example of this approach is Chapter 22, "Infrastructure Service- and Support-Delivery Controls, on the information technology infrastructure library (ITIL) standards for information systems service-delivery and service-support standards. This may become an important set of standard practices for many organizations in the future. However, in covering a broad set of topics, space does not allow for detailed discussions of areas discussed in separate chapters such as business continuity planning or audit sampling.

This edition should provide today's internal auditor with an introduction to many practices important to internal auditing. To the internal audit manager or chief audit executive (CAE), the chapters that follow are designed to give an overview of all aspects of modern internal auditing. To the staff internal auditor, the chapters are designed to give some information that should be of importance to the internal audit professional, such the previously referenced ITIL model or the Chapter 5, "Understanding and Assessing Risks: Enterprise Risk Management," discussion of the soon to be released (at the time of publication) of the COSO Enterprise Risk Management (ERM) framework.

These chapters should also be important to members of the audit committee of the board of directors as well as senior managers in the organization who deal with internal auditors on a regular basis. The chapters should provide an overview of what internal audit does, its operating practices, and the standards that create to day's profession of modern internal auditing.

PART ONE

Foundations of Internal Auditing

CHAPTER ONE

Foundations of Internal Auditing

1.1 WHAT IS INTERNAL AUDITING?

An effective way to begin this book about modern internal auditing is to refer to the professional standards of the Institute of Internal Auditors (IIA). This internal auditor professional organization defines the practice of internal auditing as follows: *Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.*

This statement becomes more meaningful when one focuses on its key terms. *Auditing* suggests a variety of ideas. It can be viewed very narrowly, such as the checking of arithmetical accuracy or physical existence of accounting or other business records, or more broadly, as a thoughtful review and appraisal at the highest organizational level. In this book, we use the term *auditing* to include this total range of levels of service, from detailed checking of accounting balances to higher-level operational appraisals.

The term *internal* defines work carried on within the organization by its own employees. Internal auditing work is distinguished from such audit-related work carried on by outside public accountants or other parties (such as government regulators) who are not directly a part of an organization.

The remainder of the IIA's definition of internal auditing covers a number of important terms that apply to the profession:

- *Independent* means auditing that is free of restrictions that could significantly limit the scope and effectiveness of the review or the later reporting of resultant findings and conclusions.
- *Appraisal* confirms the need for an evaluation that is the thrust of internal auditors as they develop their conclusions.
- *Established* confirms that internal audit is a formal, definitive function in the modern organization.
- *Examine and evaluate* describe the active roles of internal auditors, first for fact-finding inquiries and then for judgmental evaluations.

- *Its activities* confirm the broad jurisdictional scope of internal audit work that applies to all of the activities of the modern organization.
- *Service* reveals that help and assistance to management and other members of the organization are the end products of all internal auditing work.
- *To the organization* confirms that internal audit's total service scope pertains to the entire organization, including all personnel, the board of directors and its audit committee, stockholders, and other interested stakeholders.

Internal auditing can also be recognized as an organizational control that functions by measuring and evaluating the effectiveness of other controls. When an organization establishes its planning and then proceeds to implement its plans in terms of operations, it must do something to monitor the operations to ensure the achievement of its established objectives. These further efforts can be thought of as *controls*. While the internal audit function is itself one of the types of controls used, there is a wide range of other controls. The special role of internal audit is to help measure and evaluate those other controls. Thus, internal auditors must understand both their own role as a control function and the nature and scope of other types of controls in the organization.

Internal auditors who do their job effectively become experts in what makes for the best possible design and implementation of all types of controls. This expertise includes understanding the interrelationships of various controls and their best possible integration in the total system of internal control. It is thus through the control door that internal auditors come to examine and evaluate all organizational activities to provide maximum service to the organization. Internal auditors cannot be expected to equal—let alone exceed—the technical and operational expertise pertaining to the many activities of the organization. However, internal auditors can help the responsible individuals achieve more effective results by appraising existing controls and providing a basis for helping to improve those controls.

1.2 INTERNAL AUDITING HISTORY AND BACKGROUND

It is normal for any activity—including a control activity such as internal auditing—to come into being as a result of emerging needs. The business organization of 1942, when modern internal auditing was just getting started, was very different from our twenty-first century organization of today. For example, aside from some electromechanical devices and activities in research laboratories, computer systems did not exist. Organizations had no need for computer programmers until these machines started to become useful for various record keeping and other computational functions. Similarly, organizations had very rudimentary telephone connections where switchboard operators routed all incoming calls to a limited number of desktop telephones. Today, we are all connected through a vast, automated worldwide web of telecommunications and the Internet. The increasing complexity of modern business and other organizations has created the need for a similar specialist in various business controls: the internal auditor. We can better understand the nature of internal auditing today if we know something about the changing conditions in the past and the different needs these

changes created. What is the simplest or most primitive form of internal auditing and how did it come into existence? How has internal auditing responded to changing needs?

At its most primitive level, a self-assessment or internal auditing function can exist when any single person sits back and surveys something that he or she has done. At that point, the individual asks him- or herself how well a particular task has been accomplished and, perhaps, how it might be done better if it were to be done again. If a second person is involved in this activity, the assessment function would be expanded to include an evaluation of the second person's participation in the endeavor. In a small business, the owner or manager will be doing this review to some extent for all enterprise employees. In all of these situations, the assessment or internal audit function is being carried out directly as a part of a basic management role. However, as the operations of an organization become more voluminous and complex, it is no longer practicable for the owner or top manager to have enough contact with every aspect of operations to satisfactorily review their effectiveness. These operations review responsibilities need to be delegated.

Although this hypothetical senior manager could build a supervisory system to try to provide a personal overview of operations, that same manager will find it increasingly difficult to know whether all of the interests of the organization are being properly served as it grows larger and more complex. Are established procedures being complied with? Are assets being properly safeguarded? Are the various employees functioning efficiently? Are the current approaches still effective in the light of changing conditions?

The ultimate response to these questions is that the manager must obtain further help by assigning one or more individuals to be directly responsible for reviewing activities and reporting on the previously mentioned types of questions. It is here that the internal auditing activity comes into being in a formal and explicit sense. The first internal auditing assignments usually originated to satisfy very basic and sharply defined operational needs. The earliest special concern of management was whether the assets of the organization were being properly protected, whether company procedures and policies were being complied with, and whether financial records were being accurately maintained. There was also considerable emphasis on maintenance of the status quo. To a great extent, this internal auditing effort was initially viewed as a closely related extension of the work of external auditors.

The result of all of these factors was that these early internal auditors were viewed as playing a relatively narrow role in their organizations, with limited responsibility in the total managerial spectrum. An early internal auditor often was viewed as a financially oriented checker of records and more of a police officer than a coworker. In some organizations, internal auditors had major responsibilities for reconciling canceled payroll checks with bank statements or checking their mathematics in regular business documents. In retail organizations, internal auditors often were responsible for reconciling daily cash sales to recorded sales receipts.

Understanding the history of internal auditing is important because this old image still persists, to some extent, for today's modern internal auditors. This is so even though the character of the internal auditing function is now very different.

Over time, the operations of various organizations increased in volume and complexity, creating managerial problems and new pressures on senior management. In response to these pressures, management recognized the possibilities for better utilization of their internal auditors. Here were individuals already set up in an audit function, and there seemed to be every good reason for getting greater value from these individuals with relatively little increase in cost.

At the same time, internal auditors perceived these opportunities and initiated new types of services themselves. Thus, internal auditors gradually took on broader and more management-oriented responsibilities in their work efforts. Because internal auditing was initially largely accounting-oriented, this upward trend was felt first in the accounting and financial-control areas. Rather than just report the same accounting-related exceptions—such as some documentation lacking a supervisor's initials—internal auditors began to question the overall control processes they were reviewing. Subsequently, internal audit valuation work began to be extended to include many nonfinancial areas in the organization.

In 1942, the Institute of Internal Auditors (IIA) was launched. Its first membership chapter was started in New York City, with Chicago soon to follow. The IIA was formed by people who had been given the title internal auditor by their organizations and who wanted to both share experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over subsequent years and has resulted in the type of modern internal auditor discussed in this book.

New business initiatives, such as the COSO (Committee of Sponsoring Organizations) internal control framework discussed in Chapter 4, "Internal Controls Fundamentals: COSO Framework," or the Sarbanes-Oxley Act (SOA) discussed in Chapter 3, "Internal Audit in the Twenty-First Century: Sarbanes-Oxley and Beyond," and Chapter 6, "Evaluating Internal Controls: Section 404 Assessments," have caused a continuing increase in the need for the services of internal auditors. In addition, some newer environmental forces have created needs in such areas as protection from industrial hazards, support of quality-control programs, and different levels of business responsibility, including ethical standards. This need for ethical standards includes higher standards for corporate governance, greater involvement of boards of directors and their audit committees, a more active role for stockholders, and a changed role for the outside public accountant.

Ethics, whistleblower programs, and codes of conduct issues will be discussed in Chapter 9, "Whistleblower Programs and Codes of Conduct." As a result of these new business directions, the services of internal auditors have become more important to a wide range of interested parties in the organization. There are now more and better-qualified internal auditing personnel and a higher level of organizational status and importance attached to them. The IIA has grown from its first, 25-member charter chapter in 1942, to an international association with over 90,000 members and hundreds of local chapters worldwide. At the same time, the importance of internal audit has been recognized by many professionals through their Standards for the Professional Practice of Internal Auditing, as will be discussed in Chapter 12, "Internal Audit Professional Standards." The internal audit profession has reached a major level of maturity and is well positioned for continuing dynamic growth.