

Second Edition

The
essential
guide to
internal auditing

K H Spencer Pickett

THE ESSENTIAL GUIDE TO
INTERNAL AUDITING

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This book is dedicated with love to my wife, Jennifer, and
my two children, Dexter and Laurel-Jade

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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

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.

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 than 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

committee composed of nonexecutive directors. Since then, most stock exchange rules around the world require listed companies to have an audit committee and most also require an internal audit presence.

Professionalism The Institute of Internal Auditors has some history going back over 50 years. *Brink's Modern Internal Auditing* has outlined the development of the IIA:

In 1942, IIA was launched. Its first membership was started in New York City, with Chicago soon to follow. The IIA was formed by people who were given the title internal auditor by their organizations and 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.⁵

The importance of sound organizational systems came to the fore in the US where the Foreign Corrupt Practices Act, passed in 1997, stated that an organization's management was culpable for any illegal payments made by the organization even where they claimed they had no knowledge of the payments. The only way to ensure legality and propriety of all payments was to install reliable systems and controls. The systems-based approach offers great potential with the flexibility in applying this approach to a multitude of activities and developing a clear audit methodology at corporate, managerial and operational levels. Many internal audit shops have now moved into risk-based auditing, where the audit service is driven by the way the organization perceives and manages risk. Rather than start with set controls and whether they are being applied throughout the organization properly, the audit process starts with understanding the risks that need to be addressed by these systems of internal control. Much of the control solution hinges on the control environment in place and whether a suitable control framework has been developed and adopted by the organization. Internal audit can provide formal assurances regarding these controls. Moreover, many internal audit shops have also adopted a consulting role, where advice and support are provided to management.

There is no linear progression in audit services, with many forces working to take the profession back to more traditional models of the audit role where compliance and fraud work (including financial propriety) are the key services in demand. Many of the trends behind the development of internal audit point to the ultimate position where the audit function becomes a high-profile autonomous department reporting at the highest level. This may depend on moving out audit functions currently based in accountancy. The true audit professional is called upon to review complicated and varied systems even if the more complicated and sensitive ones may sometimes be financially based. A multidisciplinary approach provides the flexibility required to deal with operational areas. Again, this move is strengthened by the growing involvement in enterprise-wide risk management. The latest position is that there is normally no longer a clear logic to the chief audit executive to continue to hold a reporting line to the DF. The debate now revolves around whether the CAE should report directly into the main board and not just to the audit committee.

The Expectation Gap

Audit services will have to be properly marketed, which is essentially based on defining and meeting client needs. This feature poses no problem as long as clients know what to expect from their internal auditors. It does, however, become a concern when this is not the case, and

there is a clear gap in what is expected and what is provided. Management may want internal auditors to:

- Check on junior staff on a regular basis.
- Investigate fraud and irregularity and present cases to the police and/or internal disciplinaries.
- Draft procedures where these are lacking.
- Draft information papers on items of new legislation or practice.
- Investigate allegations concerning internal disputes and advise on best resolution.
- Advise on data privacy and security, and check that the rules are complied with.
- Identify key risks for senior management.

One cannot give up professional integrity but, at the same time, the above expectations cannot simply be ignored. If new resources are brought in to cover these services, they may end up competing for the internal audit role. It is important not to sacrifice assurance work by diverting audit resources to carrying out pure consulting services. We must also keep an eye on the wider societal expectations. If internal audit is seen as professionally independent, then there will come a time when audit reports will be of increasing interest to stakeholders who sit outside the corporate entity.

The emergence of a Governance, Risk and Compliance process in many larger organizations derives from an attempt to integrate these three concepts into a meaningful whole. New legislation and regulations should be considered and the effects anticipated. The audit strategy and business plan should take on board these additional factors in a way that promotes the continuing success of the audit function. This means that the CAE must resource the continual search for new legislation that affects the organization's control systems or impacts on the future of internal audit. As suggested by the current definition of internal auditing, these three concepts now form the framework for the design and provision of the internal audit service. One major issue is the growth of risk committees that are being established by main boards along with the appointment of high-level chief risk officers, and the impact this has on the internal audit role. This is why the next three chapters deal with these topics.

Summary and Conclusions

This first chapter of *The Essential Guide* takes the reader through the structure of the book and highlights the pivotal role of the IIA standards. We have also provided a brief snapshot of the development of the internal audit role as an introduction to the subject. Many of the points mentioned above are dealt with in some detail in the main part of the book, although it is as well to keep in mind the basics of internal audit while reading more widely. The concept of internal audit is really quite simple – it is the task of putting the ideals into practice that proves more trying. Internal auditors have a noble history as guardians of good governance and as the need for better accountability becomes more profound, the auditor will need to step further and further into the corporate spotlight. We have mentioned Sawyer's views in this chapter, which is why we close with another quote on the wide range of benefits from a good internal audit team:

IA can assist top management in:

- monitoring activities top management cannot itself monitor
- identifying and minimizing risks

- validating reports to senior management
- protecting senior management in technical analysis beyond its ken
- providing information for the decision-making process
- reviewing for the future as well as for the past
- helping line managers manage by pointing to violation of procedures and management principles.⁶

Whatever the new risk-centric jargon used to describe the audit role, much of the above benefits described by Sawyer remain constant. For those embarking on a career in internal auditing, these are exciting new times, where the contribution of the competent auditor will be immense in helping locate integrity and transparency right at the forefront of the way large organizations are governed.

Endnotes

1. Sawyer, Lawrence B. and Dittenhofer, Mortimer A., Assisted by Scheiner, James H. (1996) *Sawyer's Internal Auditing*, 4th edition, Florida: The Institute of Internal Auditors, p. 8.
2. Flesher, Dale (1996) *Internal Auditing: A One-Semester Course*, Florida: The Institute of Internal Auditors, pp. 5–6.
3. Internal Auditing (2002) *Distance Learning Module*, Institute of Internal Auditors UK&Ireland.
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5. Moeller, Robert and Witt, Herbert (1999) *Brink's Modern Internal Auditing*, 5th edition, New York: John Wiley & Sons, Inc.
6. Sawyer, Lawrence B. and Dittenhofer, Mortimer A., Assisted by Scheiner, James H. (1996) *Sawyer's Internal Auditing*, 4th edition, Florida: The Institute of Internal Auditors, p. 13.

Chapter 2

CORPORATE GOVERNANCE PERSPECTIVES

Introduction

Corporate governance is a term that, over the years, has now found its way into popular literature. It has been described by Sir Adrian Cadbury as the way organizations are directed and controlled. This simple statement contains many profound elements including the performance/conformance argument of whether good governance is about complying with codes of practice or whether it also underpins better business performance. There is also some debate as to whether companies should follow a fixed set of rules or be guided by less rigid principles. An organization's main task is to achieve the level of performance that it was established for. However, at the same time, it must adhere to all relevant standards, rules, laws, regulations, policies and expectations that form a framework within which this performance will be assessed. This, in turn, may cause many difficulties in the real world. Our first reference to corporate governance comes from Ireland:

Improved standards of corporate governance, like 'motherhood', cannot be argued against. It is critical to a small economy like Ireland, which is seeking to develop business in the more sophisticated sectors, that we are seen to operate to high standards.¹

A widely reported case, involving a large law firm, recounts the pressures placed on the legal teams who were told to charge a set number of fee paying hours each month, which resulted in the routine falsification of timesheets to achieve this target. While the firm's performance was excellent, as measured in terms of income achieved, it broke many rules in its charging practices and even committed the criminal offence of false accounting; i.e. there was little conformance with rules, procedures and ethical values. The firm's tone at the top was weak in that it created a culture of abuse and control was lacking in that routine working practices broke many rules. Short-term gains in income were secured, while in the long run a great deal of damage was done to the firm's reputation when the scandal was eventually uncovered. The firm's partners, investors, employees and everyone else connected with the entity expected a high return, so the pressures this expectation created built up to force otherwise perfectly respectable people to falsify their charge sheets.

This simple illustration can be multiplied many times in all major developing and developed economies to give an insight into the type of problem that undermines the foundations of both business and public services. Moreover, there are many well-known corporate scandals involving large companies and public sector bodies that have occurred with frequent regularity over the years, each serving to undermine public trust in large organizations. Corporate governance codes and policies have come to be relied on to reestablish the performance/conformance balance to help ensure integrity, openness and accountability. The codes call for boardroom arrangements that support these three ideals and the internal audit function is a key component of governance

structures in promoting good governance as part of the audit review process. The internal auditor who has a sound grasp of corporate governance is best placed to play a major role in the drive to ensuring sustainability as well as success in all business and service sectors. 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. The sections covered in this chapter are:

- 2.1 The Agency Model
- 2.2 Corporate Ethics and Accountability
- 2.3 International Scandals and Their Impact
- 2.4 Models of Corporate Governance
- 2.5 The Institute of Internal Auditors
- 2.6 The External Audit
- 2.7 The Audit Committee
- 2.8 Internal Audit
- 2.9 The Link to Risk Management and Internal Control
- 2.10 Reporting on Governance, Risk and Internal Controls
- 2.11 New Developments
- Summary and Conclusions

2.1 The Agency Model

The main driver for corporate governance is based on the agency concept. Here corporate bodies are overseen by directors who are appointed by the owners, i.e. the shareholders. The directors formulate a corporate strategy to achieve set objectives and meet market expectations, and, in turn, employ managers and staff to implement this strategy. Throughout the course of this chapter we will develop a simple model that will set out the main elements of one version of the corporate governance framework, starting with Figure 2.1.



FIGURE 2.1 Corporate governance (1).

If everyone was totally competent and totally honest then the model in Figure 2.1 would work quite well. The shareholders appoint the board of directors who oversee their managers, while managers run the business through their operational and support staff, led by a combination

of team leaders, supervisors and unit heads. To achieve their published objectives the directors set targets for their management team, authorize a budget and then establish a mechanism for measuring performance. All business activity feeds into the accounting system and the directors report the results back to their shareholders in the annual report on performance and accompanying final accounts. Shareholders check the overall performance and financial results each year and ensure that their investment is intact. They have a right to any dividends and may well see a growth in the value of their investment through strong share prices. Meanwhile, the directors have a duty to take all reasonable steps to protect the business and account for their activities. The Stewardship concept means directors owe this responsibility to the parties who have a vested interest in the organization. They work for and on behalf of the owners and need to demonstrate adequate competence. A hint at what could go wrong with this simple model is illustrated by the following article:

Many directors have virtually no idea of their powers, or of the legal obligations that they face Examples of rules directors commonly break – either deliberately or unintentionally – include: borrowing money from companies over which they exercise control; failing to hold and minute board meetings as and when required by law; failing to declare an interest in contracts that involve the company; blindly battling to save a company in difficulties or technically insolvent when this presents a risk to the creditors; failing to understand the ‘five year’ directors’ employment contract rule.²

There are further mechanisms that need to be included in our model to reflect both the performance and accountability dimensions that are important in agency theory, i.e. strategic performance measures and published accounts, shown in Figure 2.2.

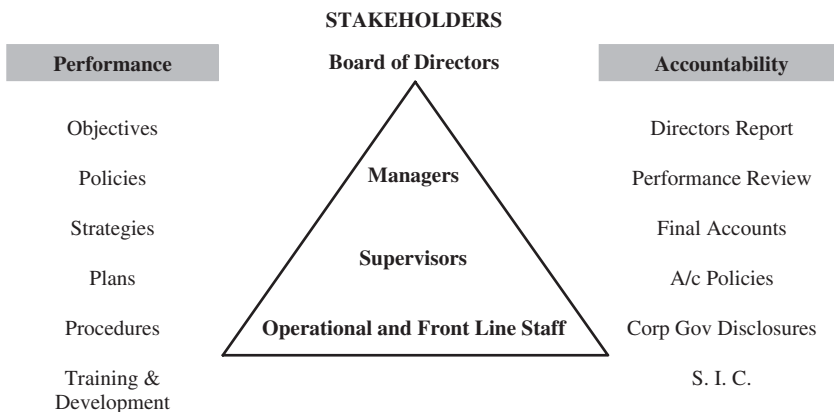


FIGURE 2.2 Corporate governance (2).

The board will set out the corporate objectives and strategy to achieve these objectives, formed within the defined policies that constrain the way the workforce behaves. Plans, procedures and well-trained staff will work to deliver their team and personal targets. Again, this simple model means that the shareholders get the performance returns they signed up to. The right side of the model closes the loop whereby the board reports formally back to the shareholders through the annual report and accounts. Most regulations require the disclosure of adopted governance

arrangements and the statement of internal control (SIC), which says that controls are sound and work. In the past this model of basic corporate governance was used to establish the corporate entity, whereby owners used managers to run their investment and report back on results. Notice that the term 'shareholders' has been replaced with the term 'stakeholders' in our model, and this change is now explained.

Defining Stakeholders

The agency model is based on changing the one-dimensional concept of *shareholders* to the wider concept of *stakeholders*. Most commentators argue that corporations need to acknowledge a wide range of people and groups affected by their operations and presence. Andrew Chambers has devised a 'Court of public opinion' as consisting of key figures including:

Customers	Regulators
Financiers	Business partners
Politicians	Shareholders
The media	Competitors
Employees	Government
Business leaders	Local communities ³

This does not mean the shareholders can be sidelined in preference to all groups that come into contact with an organization. Shareholders have a right to have their investment managed with care and should expect some return (dividends) from the enterprise. They can vote on important matters such as who should be in charge of the company and how much they should receive for this task. Companies are paying much more attention to the needs of the shareholders and, as one commentator states:

Twenty years ago management had scant if any regard for shareholders, unless they were part of the family! In the 1980s two things happened. One, management thought they had better start talking to investors because they could sack the board. Then we had firms being bid for and normally they weren't the ones which had achieved much. As they tried to defend what they had done, you heard the great cry of short-termism which really meant – we failed to perform for the last three years but don't worry, we will do for the next three. Suddenly the bulb went on in our brains that we had power and could influence management. Boards also recognised they had to talk to their shareholders. Today we do have sensible dialogues.⁴

Providing lots of information to the shareholders may represent good intentions but at times information alone may not be enough:

Royal Bank of Scotland's annual report, published this week, devoted seven pages to executive pay. Barclay's report has eight if you count the page on directors' pay. Every year, it gets harder for the reader to have a clue what is really going on. It is now virtually impossible to grasp how generous these schemes could be. Even remuneration consultants who devise them admit to being frequently baffled, at least when trying to unpick them on the basis of the information published in the annual report.⁵

In general there are two types of stakeholders: those that have a direct *influence* on the organization's future activities, such as investors, customers, regulators and shareholders, and