EIGHTH EDITION

ROBERT MOELLER

Brink's MODERN INTERNAL AUDITING

A Common Body of Knowledge

Brink's Modern Internal Auditing

Eighth Edition

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Dedicated to my best friend and wife, Lois Moeller.
Lois has been my companion and partner for over 45 years,
whether we are somewhere in the world visiting an interesting historical location,
attending one of Chicago's many music and theater events,
gardening vegetables in the backyard,
or finding the right wine and cooking the produce.

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Preface

THIS BOOK IS A COMPLETE guide and a definition of a common body of knowledge (CBOK) for the processes and profession of internal auditing—what professionals need to know to successfully perform individual internal audits and what an enterprise needs to know to launch an effective internal audit function. With a heritage that goes back to the first days of internal auditing after World War II when Victor Brink produced the first edition, the chapters following outline a professional CBOK and describe internal auditing today. Although it is often misused, the word *modern* beginning with the title of the first edition says a lot about this book's heritage and the contemporary practice of internal auditing. In the first edition it described a new and evolving profession. The early internal auditors were often little more than accounting clerks or clerical support staff for their external auditors. Brink envisioned them as professionals performing much broader services to management.

Due to the pervasiveness of information technology processes and the Internet in all areas of commerce, the rules for a consistent definition of internal controls, and our evolution to a truly global economy, internal auditors today must operate in an ever-changing environment. Internal auditors need increasing levels of knowledge and understanding in many areas, but sorting through what is important and what is just nice to know represents challenges for internal auditors at all levels. This newly revised eighth edition discusses modern internal auditing in terms of areas where there is a strong knowledge requirement as well as other areas where only a general level of knowledge is needed. This edition updates our three common CBOKs for the profession of internal auditing.

The practice of internal auditing is important to enterprises today worldwide, and senior management members, government regulators, and other professionals need to have a general understanding and set of expectations of the roles and capabilities of internal auditors. That is, just as internal auditors need a CBOK to better define their profession, the outside world needs to better understand internal auditors and how they can serve management at all levels.

The following chapters describe this CBOK for internal auditors—knowledge areas that should be important to all internal auditors, no matter their level of experience, their business area, or where they are working in the world. The CBOK topics presented here are not based on surveys of what other internal auditors are doing today; they are based on this author's long-term, 40-plus years of experience in internal auditing as well as his extensive professional activities and research.

The following are some of the CBOK elements found in each chapter:

Part One: Foundations of Modern Internal Auditing. These two introductory chapters highlight the importance of internal auditing today in all aspects of business, government, and other activities, as well as why a CBOK is important.

1. **Significance of Internal Auditing in Enterprises Today.** This introductory chapter talks about the origins of internal auditing. It does not contain key CBOK information, but provides important background knowledge and history for today's internal auditor and explains what led Victor Brink to write the first edition.
2. **An Internal Audit Common Body of Knowledge.** In this chapter, we explain and expand the concept of an internal auditing CBOK and why it is important to the profession.

Part Two: Importance of Internal Controls. The review and assessment of internal controls are key internal audit activities. The five chapters in this part describe internal control reviews in terms of the newly revised COSO internal control framework, the Sarbanes-Oxley Act (SOx) requirements, and several internal control frameworks including COBIT.

3. **The COSO Internal Control Framework.** This recently revised internal control framework has become the worldwide standard for assessing internal controls; every internal auditor needs to understand the Committee of Sponsoring Organizations (COSO) internal control framework and how to use it in internal audit assessments of internal controls.
4. **The 17 COSO Internal Control Principles.** These principles were introduced as part of the newly revised framework and provide guidance to better help internal auditors to plan and perform their reviews of internal controls.
5. **Sarbanes-Oxley Act (SOx) and Beyond.** SOx became law in the United States in 2002 and has massively changed how we assess and measure internal accounting controls almost worldwide. The chapter discusses the current status of SOx including its AS5 auditing standards and other elements of this extensive set of legislation that are particularly important to internal auditors.
6. **COBIT and Other ISACA Guidance.** In our very IT-dependent world, internal auditors need a more IT-oriented framework to help them measure and assess internal controls as part of their review efforts. The Control Objectives for Information and related Technology (COBIT) tool is important here, and all internal auditors should have a least a general understanding of this worldwide-recognized internal control framework.
7. **Enterprise Risk Management: COSO ERM.** Risk management is an important internal audit knowledge area, and internal auditors need to understand and make use of COSO Enterprise Risk Management (COSO ERM) as part of their internal audit planning and assessment activities. The chapter describes this risk assessment framework and why it is important for internal auditors.

Part Three: Planning and Performing Internal Audits. The six chapters in this part discuss some important general concepts and elements of the practice of modern internal auditing, ranging from professional governing standards to assessing those areas in the enterprise that should be candidates for internal audits.

8. **Performing Effective Internal Audits.** This chapter contains an introduction on the overall practice of planning, performing, and completing an effective internal audit. These are the steps of what it takes to perform an internal audit.
9. **Standards for the Professional Practice of Internal Auditing.** All internal auditors need to have a strong knowledge and understanding of these Institute of Internal Auditors (IIA)–issued standards. The chapter provides an overview of the more important elements of the standards and where to search for more information.
10. **Testing, Assessing, and Evaluating Audit Evidence.** A major activity in internal auditing is to examine a record or artifact of audit evidence and then to decide if it meets audit review criteria. This is a basic internal audit knowledge area that must follow internal auditing best practices.
11. **Continuous Auditing and Computer-Assisted Audit Techniques.** The ongoing growth of 24/7 systems and processes is changing the way that internal auditors should assess and evaluate internal controls. This chapter introduces online continuous monitoring tools that internal auditors should consider a key CBOK knowledge area.
12. **Control Self-Assessments and Internal Audit Benchmarking.** The IIA has developed some extensive criteria for internal auditors at any level to look at what they are doing at a point in time and then to make an assessment of that work. The chapter describes these processes as well as guidance for improving and reviewing the quality of internal audit work.
13. **Areas to Audit: Establishing an Audit Universe and Audit Programs.** There are a wide variety of areas in any enterprise that are potential candidates for review, but internal auditors should tailor that list down to what is generally known as an audit universe. The chapter provides some guidance on how to build and assess potential review areas necessary to plan and perform internal audits.

Part Four: Organizing and Managing Internal Audit Activities. The five chapters in this part discuss the process of launching, performing, and completing internal audits.

14. **Charters and Building the Internal Audit Function.** Best practices here cover the building and managing of an effective internal audit function. The chapter's theme is on how a new enterprise would launch and build its own internal audit function, including an audit committee–approved audit charter.
15. **Managing the Internal Audit Universe and Key Competencies.** Beyond the knowledge and technical skills involved in understanding the COSO internal control framework and IT general controls, internal auditors must possess some core key

competencies, such as interviewing and writing skills. These apply to all levels of an internal audit function, ranging from audit management to audit staff members. The chapter will focus on some necessary CBOK skills for all levels of internal auditors.

16. **Planning Audits and Understanding Project Management.** Whether building an audit schedule for an upcoming fiscal period or planning a specific audit engagement, internal auditors at all levels need to have an understanding of good project management techniques. This chapter discusses project management for internal auditors.
17. **Documenting Audit Results through Process Modeling and Workpapers.** As another specialized internal audit skill, internal auditors need efficient and cost-effective procedures to review and document overall business processes of all types. While many alternatives are available, this chapter will introduce some good internal audit–based approaches to understand various processes and then to document that work through audit workpapers.
18. **Reporting Internal Audit Results.** Reporting the results of audit work as well as developing recommendations for corrective actions is a major task. Whether reports are developed in hard- or soft-copy formats, this chapter will suggest approaches and guidelines for producing them effectively.

Part Five: Impact of Information Systems on Internal Auditing. Internal auditors must know how to evaluate IT controls as well as how to use IT in performing their internal audits. The six chapters in this part outline some important internal audit IT–related CBOK areas.

19. **ITIL® Best Practices, the IT Infrastructure, and General Controls.** The chapter will explain processes for reviewing IT general controls, the overall controls that cover the IT infrastructure and all aspects of IT operations. In addition, the chapter will introduce the Information Technology Infrastructure Library (ITIL®), an internationally recognized set of best practices that promote a partnership between business operations and IT functions, and explain why knowledge of ITIL® is important for internal auditors.
20. **BYOD Practices and Social Media Internal Audit Issues.** The growth of the Internet, the Internet-based nature of many systems today, and our increasing personal use of smartphones and tablet devices have introduced many changes in the manner that IT systems are managed and controlled. This chapter discusses some of the issues from an internal audit perspective and areas where internal auditors should develop a good CBOK understanding.
21. **Big Data and Enterprise Content Management.** The growth of massive IT systems coupled with legal and government requirements to capture and return this system data has led to the environment known as big data. This chapter discusses some internal control concerns in this environment as well as some internal audit knowledge needs.
22. **Reviewing Application and Software Management Controls.** In addition to the general controls covering IT operations, internal auditors need to understand how to review internal controls covering specific applications ranging from

local-office handheld and desktop procedures to larger enterprise-wide applications. This chapter will introduce some internal audit knowledge areas and some IT audit best practices.

23. **Cybersecurity, Hacking Risks, and Privacy Controls.** IT security and privacy issues are major knowledge areas that often require specialized technical skills beyond those of many internal auditors. However, this chapter will introduce some fundamental security and privacy control concepts as well as some basic internal auditor knowledge requirements in this area.
24. **Business Continuity and Disaster Recovery Planning.** Concepts such as backing up major computer files have a long internal audit–related history, with the objective of allowing the restoration of operations in the event of a calamitous interruption in IT services. This chapter will look at an expanded view of continuity planning with an emphasis on tools and procedures to get the business back in operation.

Part Six: Internal Audit and Enterprise Governance. The four chapters in this part go beyond just internal audits and discuss the relationship of an internal audit function with its board audit committee as well as the importance of such areas as governance, risk, and compliance (GRC) issues, ethics and whistleblower procedures, and fraud investigations.

25. **Board Audit Committee Communications.** Internal audit functions report to their board of directors' audit committees, per SOx rules. While this is very much an audit management responsibility, all internal auditors need to have a better understanding of their roles and responsibilities with regard to the audit committee.
26. **Ethics and Whistleblower Programs.** SOx requirements and other good enterprise governance practices call for these types of programs. There are many areas described here where internal audit can help make strong improvements to operations.
27. **Fraud Detection and Prevention.** Understanding how to recognize and detect fraud is an important internal audit skill. This chapter will discuss some basic fraud understanding techniques for internal auditors.
28. **Internal Audit GRC Approaches and Other Compliance Requirements.** There are numerous compliance rules impacting today's enterprises, but the overall concept of strong and effective GRC principles is particularly important. This chapter will provide internal auditors with some of the more important of these concepts for enterprise governance purposes.

Part Seven: The Professional Internal Auditor. The two chapters in this part focus on professional certifications for internal auditors—important career objectives—as well as internal audit's role as an internal consultant to its enterprise organization.

29. **Professional Certifications: CIA, CISA, and More.** Certifications such as the IIA's Certified Internal Auditor (CIA) are important for building professional credentials. This chapter will look at some of the more important certifications of interest to internal auditors, along with their requirements.

30. **The Modern Internal Auditor as an Enterprise Consultant.** Until very recent times, IIA standards prohibited internal auditors from acting as consultants in the same areas where they were performing internal audits. Revised IIA standards now allow an internal auditor to act as a consultant to his or her enterprise, and this chapter will discuss this internal audit role and responsibility.

Part Eight: The Other Sides of Auditing: Professional Convergence. The final part will conclude with four chapters on the importance of quality assurance auditing and the impact of International Organization for Standardization (ISO) standards on internal auditors. In addition, we will conclude by summarizing our internal audit CBOK.

31. **Quality Assurance Auditing and ASQ Standards.** The more production- and process-oriented American Society for Quality (ASQ) has its own internal audit section with audit procedures that are close to but not the same as IIA internal audit standards. We expect more professional convergence here going forward, and the chapter will discuss ASQ internal auditing procedures and their similarity to IIA materials.
32. **Six Sigma and Lean Techniques for Internal Audit.** Enterprises worldwide have adopted techniques, such as Six Sigma, to create all levels of operational efficiencies. The chapter will look at several that should be important knowledge areas for internal auditors and will consider how some of these programs can be used to enrich and expand internal audit activities.
33. **ISO and Worldwide Internal Audit Standards.** ISO quality systems standards are becoming increasingly important to most enterprises as they operate on a worldwide basis. This chapter will discuss the ISO process and will review some of the more important of these to internal auditors, no matter where they are working. The chapter will look at some important differences in internal auditing and other related global standards and will discuss the impact of internal accounting standards on all internal auditors. Although the IIA got its start as primarily a U.S.-based organization, it has now expanded to become truly global.
34. **A CBOK for the Modern Internal Auditor.** This final chapter will summarize the various topics from other chapters that highlight areas where internal auditors should have a strong knowledge, as well as others calling for a good general but less specific understanding. The result is our proposed internal audit CBOK.

While some topics and issues may change over time, with this eighth edition we are taking a stronger and more focused view on the knowledge areas that are essential to being a successful and outstanding internal auditor today.

PART ONE

Foundations of Modern Internal Auditing

CHAPTER ONE

1 Significance of Internal Auditing in Enterprises Today: An Update

THE PROFESSION OF AUDITING HAS been with us for a long time. Mesopotamian scribes in around 3000 BC utilized elaborate systems of internal controls using stone documents that contained ticks, dots, and checkmarks. Auditing has evolved over the millennia, and today we generally think of two basic types of business enterprise auditors: external and internal. An external auditor is chartered by a regulatory authority, with authority to visit an enterprise or entity to independently review and report on the results of that review. Those reviews generally cover financial statements but may involve other compliance areas. In the United States, financial external auditors are Certified Public Accountants (CPAs), who are state-licensed and follow the standards of the American Institute of Certified Public Accountants (AICPA; www.aicpa.org). However, there are many other types of external auditors in fields such as medical equipment devices, television viewer ratings, and multiple governmental areas.

Internal auditing, as discussed throughout this book, is a broader and often more interesting field. As an employee or member of an enterprise, an internal auditor independently reviews and assesses operations in a wide variety of areas, such as accounting office procedures, information technology systems controls, or manufacturing quality processes. Most internal auditors follow high-level standards established by their prime professional enterprise, the Institute of Internal Auditors (IIA; www.theiia.org), but there are many different practices and approaches to internal auditing today due to its worldwide nature and wide range of auditing activities.

The primary objective of this book is to define and describe internal auditing as it is or should be performed today—modern internal auditing—as well as to describe a *common body of knowledge (CBOK)* for internal auditing. Because of modern internal auditing's many variations and nuances, the chapters following describe and discuss it in terms of this CBOK, the key tools and knowledge areas that all internal auditors should generally use in their internal audit activities or at least know, as well as some

other knowledge areas where internal auditors should have at least a good general understanding. These are the common practices that are essential to the profession of modern internal auditing.

An effective way to begin to understand internal auditing and its key CBOK areas is to refer to the internationally recognized internal audit professional organization, the IIA, and its published professional standards that define the practice:

> 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 records, or more broadly as a thoughtful review and appraisal at the highest organizational level. Throughout this book, the term *auditing* will be used to include this total range of levels of service, from detailed checking to higher-level appraisals. The term *internal* defines work carried on within an enterprise, by its own employees, in contrast to external auditors, outside public accountants, or other parties such as government regulators who are not directly a part of the particular enterprise.

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

- *Independent* is used for auditing that is free of restrictions that could significantly limit the scope and effectiveness of any internal auditor 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 enterprise.
- *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 processes and activities of the modern enterprise.
- *Service* reveals that the help and assistance to the audit committee, management, and other members of the enterprise are the end products of all internal auditing work.
- *To the organization* confirms that internal audit's total service scope pertains to the entire enterprise, including all personnel, the board of directors, and their audit committee, stockholders, and other stakeholders.

As a small terminology point, the chapters following will generally use the term *enterprise* to refer to the whole company or business, and the term *organization* or *function* to reference an individual department or unit within an enterprise. In the chapters to come, we describe a variety of other terminology and usage conventions as we discuss a CBOK for internal auditing and internal audit professionals.

Internal auditing should also be recognized as an organizational control within an enterprise that functions by measuring and evaluating the effectiveness of other controls. When an enterprise establishes its planning and then proceeds to implement its plans in terms of operations, it must do something to monitor the operations to assure 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 organization- or function-level 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 control function and the nature and scope of other types of controls in the overall enterprise.

Internal auditors who do their job effectively become experts in what makes for the best possible design and implementation of all types of controls and preferred practices. 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 internal control door that internal auditors come to examine and evaluate all organization activities and to provide maximum service to the overall enterprise. Internal auditors cannot be expected to equal, let alone exceed, the technical and operational expertise pertaining to the many various activities of an enterprise. However, they can help the responsible individuals achieve more effective results by appraising existing controls and providing a basis for helping to improve them. In addition, because internal auditors often have a good knowledge and understanding of many organizational units or special activities within a total enterprise, their levels of understanding often exceed those of other people.

1.1 INTERNAL AUDITING HISTORY AND BACKGROUND

The need for effective control processes created the concept of internal auditing. Despite its ancient roots, however, internal auditing was not recognized as an important process by many enterprises and their external auditors until the 1930s. This recognition was primarily due to the establishment of the U.S. Securities and Exchange Commission (SEC) in 1934 and changing external audit objectives and techniques at that time. The United States as well as the rest of the world had just gone through a major economic depression. As a legislative corrective action, the SEC required that all enterprises registered with it must provide financial statements certified by independent auditors. This requirement also prompted corporations to establish internal auditing departments, but with the objective primarily to assist their independent auditors. At that time, external financial auditors were focused on expressing an opinion on the fairness of an enterprise's financial statements rather than on detecting internal control weaknesses or even clerical errors. The SEC rules precipitated auditing based on a limited sample of transactions, along with greater reliance on internal control procedures.

At that time, internal auditors were primarily concerned with checking accounting records and detecting financial errors and irregularities and often were little more than shadows or assistants to their independent external auditors. Walter B. Meigs, writing about the status of internal auditors during the 1930s, observed that "internal auditors

were either clerks assigned to the routine task of a perpetual search for clerical errors in accounting documents, or they were traveling representatives of corporations having branches in widely scattered locations."[1] Those early internal auditors were often little more than clerical helpers who carried out routine accounting reconciliations or served as clerical support personnel. Vestiges of this old definition of internal auditing continued in some places even into the early 1970s. For example, in many retail organizations in the 1970s, the "auditors" were the people who balanced cash registers (remember those?) at the close of the business day.

Although other voices said something should be done to improve and better utilize the potential of internal auditors, things really got started after Victor Z. Brink completed his college thesis on internal auditing just before going off to serve in World War II. After the war ended, Brink returned to organize and head internal auditing for Ford Motor, and his college thesis was published as the now long-out-of-print first edition of *Modern Internal Auditing.*

About that same time, in 1942, the IIA was launched. Its first chapter was started in New York City, with Chicago soon to follow. The IIA was formed by people who had been given the title of internal auditor by their enterprises and wanted to both share their experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over the years and has resulted in the multifaceted profession of the modern internal auditor discussed in this book.

The typical business enterprise of the 1940s, when modern internal auditing was just getting started, required a very different skill set than today. For example, aside from some electromechanical devices and activities in research laboratories, digital computer systems did not exist. Enterprises had no need for computer programmers until these machines started to become useful for record-keeping and other computational and accounting functions. Similarly, enterprises 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 often wireless telecommunications and the Internet. The increasing complexity of modern business and other enterprises has created the need for internal auditors to become ever-greater specialists in various business controls. We can also better understand the nature of internal auditing today if we know something about the changing conditions in the past and the different needs those 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 himself or herself how well a particular task has been accomplished, and perhaps how it might be done better. If a second person is involved in this activity, the assessment function would be expanded to include an evaluation of that 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 enterprise become more voluminous and complex, it is no longer practicable for the owner or top manager