Class discussion 2

Obtain the annual report of a listed company and from the report, identify the following.

- the chairman of the board;
- the chief executive officer;
- the executive and non-executive directors;
- the company's internal audit activity;
- the existence of an organisational chart;
- the vision and mission of the organisation;
- the members of the audit committee; and
- the company's external auditors.

If any of the above could not be identified from the annual report, provide possible reasons for this.

1.4 Summary

This chapter introduced the business environment with reference to a hypothetical case, namely Siyafunda which expanded from a sole trader to a listed company with an internal audit activity. The business structures and role-players were also briefly introduced. The Siyafunda case continues in each chapter that follows.

An Introduction to Internal Auditing 2

Contents

Objectives for this chapter:

- Understand the history of auditing and internal auditing.
- Understand the role of the Institute of Internal Auditors (IIA).
- Understand and analyse the definition of internal auditing.
- Understand the format and content of the International Professional Practices Framework (IPPF).
- Understand the purpose of standards for a profession.
- Comprehend the format and content of the International Standards for the Professional Practice of Internal Auditing *(Standards)*.

2.1 Introduction

> Necessity created internal auditing and is making it an integral part of modern business. No large business can escape it. If they haven't got it now, they will have to have it sooner rather than later, and, if events keep developing as they do at present, they will have to have it sooner (Arthur E Hald, 1944).

Today, this statement rings true more than ever. The technological changes and business expansions since 1944 would have exceeded Hald's wildest dreams. In the 21st century, many large organisations have internal audit activities and the demand for internal auditing is increasing. Internal auditing is one of the most challenging, dynamic and exciting professional careers available. Organisations and governments are constantly seeking quality assistance from internal auditors. Global corporate scandals have illustrated the need for improved governance, risk management and control processes within organisations. Internal auditors are the perfect partners for the management of any organisation, assisting them in improving these processes and systems, as well as providing assurance that these processes and systems are working effectively.

Although the internal audit profession is not new to the business environment, significant changes have occurred in the profession over the last few years. Internal auditors are not only seen as the right-hand of management in assuring that policies, plans and procedures are adhered to, they now also fulfil a consulting role, investigating and reporting on crucial issues such as business risks threatening the organisation. Internal auditors generally work in the key areas of the business and have frequent contact with the top-level decision makers. Therefore, in numerous organisations, internal auditing has become the training ground for the future executive management.

This role of internal auditors can only be fully appreciated if the internal audit profession is properly understood. With this objective in mind, an overview of the history of auditing and in particular internal auditing, the role of the Institute of Internal Auditors (IIA), the purpose of the International Professional Practices Framework (IPPF), and the changing role of internal auditing are highlighted in this chapter.

2.2 The history of auditing

Auditing is a historic process, with evidence of its existence dating back to 4000 BC, where businesses and governments in the Middle East instituted the first formal record-keeping systems. In 3500 BC, records of a Mesopotamian civilisation that were found showed tick marks, dots and check marks next to financial transactions. The Zhao dynasty in China, as well as other developing communities of the time, had similar types of systems in use – all developing a detailed system of checks and counter-checks. Thus, the first system of verification was developed.

The modern way of controlling financial activities can be traced back to the public finance systems in Babylonia, Greece, and the Roman Empire, to name a few. The biggest concerns in those times were the errors made in recording activities, and fraudulent activities performed by corrupt officials. The emergence of the double-entry bookkeeping system can be directly linked to the need for control in an attempt to minimise errors and fraud. The need for control evolved, and the Greeks and Romans developed a system where transactions in the double-entry bookkeeping system needed authorisation and verification. These control activities were called *auditus*, which means "hearing", or *audire*, which means "to hear". The word "audit", meaning "to hear whether an event is true, did occur or that all activities that occurred were recorded" is derived from these words.

The concept of auditing further evolved during the industrial revolution in England, and modern auditing was born. Written records were scrutinised and entries in the accounting records were compared to the supporting documentation. The European system of bookkeeping and auditing was also introduced in America. Englishmen wanted to invest in American companies and demanded that independent checks be performed on the financial soundness of the companies. The English auditors introduced their methods of doing audits to the Americans. In 1789, the Congress of the United States of America (USA) approved an Act that made provision for a person, called an auditor, to audit the government's records. The auditor had to receive the public accounts, scrutinise it and verify that the balances were correct.

The need for an independent and reliable verification process to assess whether funds are used efficiently and that the financial records are a true and fair reflection of the financial position and financial performance of the organisation, was the cornerstone of auditing. Today, this is still true. The need for, and use of funds from parties outside the government (taxes) or organisation (investors) remains one of the main reasons for appointing an independent or external auditor who performs an independent examination of the financial affairs of the organisation.

In the early 1900s, the concept of auditing evolved into two unique areas of specialisation, namely internal and external auditing. Economic growth made it difficult for organisations to maintain control of their business activities and operational efficiency. Management lost direct contact with most of their subordinates. To overcome the problem of controlling the activities of the organisation, people known as internal auditors were appointed to review and report on the effectiveness of governance, risk management and control processes within the organisation. The modern concept of internal auditing was born during this time.

The evolution of internal auditing into a profession is highlighted in the next section.

2.3 The history of internal auditing

Originally, the role of internal auditing was to test the reliability of information that was incorporated in the financial statements. Companies in the railroad, defence and retail industries were the first to employ internal auditors. In the 19th century, the executives of the railroad companies wanted assurance that the railroad ticket agents across the country were declaring all income collected from ticket sales. They appointed independent reviewers to provide assurance that the railroad ticket agents were in fact handling the money appropriately. The internal auditors had to travel quite extensively to get to all of the railroad ticket agents across the country and thus the first internal auditors were called "travelling auditors". Both World War I and II provided tremendous impetus to the profession of internal auditing. With the shift to a war economy, management became concerned with compliance with government regulations as well as the availability of labour and materials. Cost analysis and the effective and efficient managing of resources became more important than external financial reporting.

Some of the factors contributing to the development of internal auditing within organisations included:

- the effect of increasing numbers of transactions;
- the complexity of the transactions;
- the owner or manager being removed from the place where activities occurred (decentralisation and the agency theory);
- management faced an expanded span of control;
- potential subjective reporting from line managers;
- technical expertise needed to meaningfully review business activities; and
- the need for management to have eyes and ears in the field.

The tasks performed by the internal auditors varied from the checking of routine financial and operational activities, to analysing and appraising these activities. The activities of internal auditing expanded from being a watchdog (performing assurance activities for management) to being a guide-dog (assisting and advising management with their activities). The modern internal auditor's responsibility is as broad as the current business environment. Internal auditors need to add value to an organisation by assessing whether activities performed by the organisation are done economically, efficiently and effectively. Thus, foreseeing potential risks as well as identifying existing risks that can threaten the organisation as a whole, incorporating governance in their audit activities, assessing whether the organisation keeps up with the latest technology and processes, and much more. These responsibilities will be dealt with in more detail in at a later stage.

Internal auditors have to be flexible and able to adapt to changing situations. An institute for internal auditors was founded to look after the needs and expectations of its

members, and to guide them in the continuously changing environment in which they practice their profession.

2.4 The Institute of Internal Auditors

2.4.1 History of the Institute of Internal Auditors

As the profession evolved, internal auditors demanded greater recognition of their profession, and on 17 November 1941, the Institute of Internal Auditors (IIA) was established in the USA, representing a landmark for the profession. The initial purpose of the IIA was to provide internal auditors with an opportunity to share their common interests and concerns.

Internal auditors in different organisations made contact with one another and began to share new ideas and identify solutions to similar problems. Three individuals, namely John B Thurston, Robert B Milne and Victor Z Brink, identified 40 individuals in the internal audit environment and asked them if they would be interested in forming an institute for internal auditors. Twenty-four agreed to be part of this exciting opportunity and a charter was subsequently drawn up stipulating the terms of reference of the Institute.

The charter of the IIA indicated the official purpose of the Institute as being:

- the cultivation, promotion and dissemination of knowledge and information concerning internal auditing and subjects related thereto;
- the establishment and maintenance of high standards of integrity, honour and character among internal auditors;
- furnishing information regarding internal auditing and the practice and methods thereof to its members and other persons interested therein, and to the general public;
- to cause the publication of articles relating to internal auditing and practices and methods thereof;
- the establishment and maintenance of a library and reading rooms, meeting rooms and social rooms for the use of its members;
- the promotion of social intercourse among its members; and
- doing any and all things which are lawful and appropriate in the furtherance of any of the purposes expressed in the charter.

2.4.2 The Institute of Internal Auditors' timeline of significant events

From its incorporation, the newly formed Institute grew in leaps and bounds. The following list highlights some of the important milestones within the IIA (obtained from the IIA website) including the internal audit landscape in South Africa:

- 1941: Apart from being the launch year, Victor Z Brink published the first book on internal auditing.

- 1947: The Statement of Responsibilities of the Internal Auditor was published.
- 1957: The Statement of Responsibilities of the Internal Auditor was revised to include operational responsibilities.
- 1968: The Code of Ethics was approved by the IIA board of directors.
- 1969: The board approved the idea of a certified qualification for internal auditing.
- 1973: The Certified Internal Auditor (CIA) programme was established.
- 1974: The first CIA examination was written.
- 1976: The USA Civil Service Commission acknowledged the CIA designation as equal to the Certified Public Accountant (CPA) designation.
- 1977: The Foreign Corrupt Practices Act was passed, making management liable for any fraud committed within the organisation. If it was proven that management was innocent, they could still be charged for the fact that the systems in place to detect illegal activities did not operate efficiently. Therefore, more emphasis was placed on internal controls and more internal auditors were needed. Membership of the IIA increased dramatically following this Act's passing.
- 1978: The Standards for the Professional Practice of Internal Auditing, consisting of five general standards and 25 specific standards, were approved (hereafter referred to as *Standards*).
- 1987: The number of internal auditors increased as a result of the Treadway Commission Report being issued. The report concluded that every public organisation should have an internal audit activity and there should be an audit committee consisting of non-executive directors.
- 1989: The IIA was granted consultative status by the United Nations in New York.
- 1992: The Committee of Sponsoring Organisations (COSO) published a detailed report (COSO I – Internal Control: Integrated Framework) on internal control and the criteria for the evaluation of an effective internal control system.
- 1994: The first King Report on Corporate Governance was issued by the Institute of Directors in South Africa, recommending the establishment of an internal audit activity within organisations.
- 1999: The third Common Body of Knowledge (CBOK) study was conducted. The first Competency Framework for Internal Auditors (CFIA) was issued, as well as a new definition for internal auditing.
- 1999: The Public Finance Management Act (PFMA) was promulgated requiring all South African public sector organisations to establish an effective internal audit activity.
- 2000: The new International *Standards* were introduced to address the increasing scope of internal auditing and the changing business environment.
- 2002: The *Standards* became mandatory guidelines for all internal auditors and internal audit activities.
- 2002: The second King Report on Corporate Governance was issued by the Institute of Directors in South Africa, recommending the establishment of an effective internal audit activity within organisations.

- 2002: The corporate scandals of Enron and WorldCom were uncovered, and in the USA, the Sarbanes-Oxley Act (SOX) was passed to try to prevent such events in the future. This Act put the spotlight on internal control, and along with it, the demand for internal auditors grew.
- 2003: The Professional Practices Framework (PPF), consisting of the *Standards*, the Code of Ethics, Practice Advisories, and Development and Practice Aids, was issued.
- 2003: The Municipal Finance Management Act (MFMA) was promulgated for local government in South Africa, requiring the establishment of an effective internal audit activity.
- 2004: The PPF was revised.
- 2004: COSO published a second report (COSO II – Enterprise Risk Management: Integrated Framework) incorporating the new focus area for internal auditors, namely risk management.
- 2005: The IIA celebrated its 100 000th member.
- 2005: The South African National Treasury issued Treasury Regulations for departments, trading entities, constitutional institutions and public entities in terms of the PFMA providing detailed guidance on the establishment and functioning of the internal audit activity.
- 2006: The fourth Common Body of Knowledge (CBOK) study was conducted globally to determine the knowledge and skills required of professional internal auditors (the previous three CBOK studies were conducted in 1972, 1985 and 1999 respectively).
- 2009: The PPF was revised and the title changed to International Professional Practices Framework (IPPF).
- 2009: The third King Report on Governance was issued by the Institute of Directors in South Africa, providing comprehensive guidance on the role and responsibilities of internal auditing, within both private and public sector organisations.
- 2010: The fifth Common Body of Knowledge (CBOK) study was conducted globally to determine the knowledge and skills required of professional internal auditors.
- 2012: The IIA split into the IIA Global and the IIA North America. The second draft Competency Framework for Internal Auditors was issued.

  2012: COSO I was in the process of being revised.
- 2013: The IIA published the Global Internal Audit Competency Framework (IACF).
- 2013: COSO published a revised framework for internal control, generally referred to as COSO 3, replacing COSO 1.
- 2014: The IIA in South Africa (IIA-SA) launched its formal professional training programme for internal auditors.
- 2015: The sixth Common Body of Knowledge (CBOK) study was conducted globally to determine amongst others, the knowledge and skills required of professional internal auditors.

- 2015: The composition of the IPPF was revised.
- 2016: The fourth King Report on Corporate Governance was issued by the Institute of Directors in South Africa, emphasising the role and responsibilities of an effective, risk-based internal audit activity.

2.4.3 The Institute of Internal Auditors today

Currently members of the IIA come from a variety of public and private sector organisations. Members include engineers, doctors, architects, accountants, manufacturers and many more. The IIA has grown to nearly 200 000 members in over 165 countries. The organisation is a dynamic institution that serves the needs of its various members. The motto of the IIA, "Progress through sharing", is evident in the way the Institute encourages its members to attend seminars, conferences and continuous professional education (CPE) and training events, to share their ideas and enhance professionalism. The international website, www.globaliia.org, has information on all the latest developments, materials and activities to assist individuals to perform internal audit engagements with due professional care.

The IIA is the world leader in internal auditing and acts as direction indicator to its members. It presents conferences, seminars, conducts valuable research, certifies newly qualified internal auditors, produces educational products and provides quality assurance reviews and benchmarking standards.

The IIA's **core purpose** (obtained from *www.globaliia.org*) is to lead the global profession and advance its value.

The **vision** of the IIA (obtained from www.globaliia.org) is that internal audit professionals will be universally recognised as indispensable to effective governance, risk management, and control.

The **goals** of the IIA (2015–2020) (obtained from www.globaliia.org) are to:

- lead the profession through the development of timely and relevant knowledge, global guidance, and career path guidelines;
- raise the profile of and demand for the profession to ensure it is recognized as an indispensable resource by key stakeholders;
- be recognised as the leading voice for internal auditing;
- collaborate globally to expand the capacity of the profession; and
- deploy both financial and business models that generate sustainable value for members.

The worldwide growth in the profession led to a demand for local internal audit institutes to be formed in countries other than the USA. Countries have chapters, affiliates, and/or regional offices. As a result of the rapid growth of the profession, the IIA recently created a global headquarters (IIA-Global) separate from North America. The IIA Global governs over all the chapters, affiliates and regional offices. IIA North America is the largest region in the world. IIA-SA is the second largest institute in the world and has

11 regions as well as three regions in neighbouring countries; the Chartered Institute of Internal Auditors in the United Kingdom and Ireland, the third largest institute in the world, has nine regions; and Australia, the fourth largest, has seven chapters. All these bodies report to the IIA-Global at various levels. Although each affiliate or institute operates as an individual unit, certain minimum requirements remain the prerogative of the IIA-Global.

2.4.4 The Institute of Internal Auditors South Africa

The Institute of Internal Auditors South Africa (IIA-SA) was established on 17 November 1964 as a non-profit organisation under Section 21 of the Companies Act, 61 of 1973 and is affiliated to the IIA-Global, with its head office in the USA, as a national institute. Currently, IIA-SA has more than 10 000 members.

According to Dr Claudelle von Eck, the current chief executive officer of IIA-SA, the internal audit profession in South Africa has grown significantly in the past decade. She attributes this growth to the string of corporate failures, and the subsequent recommendations by the King reports on governance (issued in 1994, 2002 and 2009 respectively) as well as legislation such as the Public Finance Management Act, 1 of 1999 (PFMA), and the Local Government: Municipal Finance Management Act, 56 of 2003 (MFMA), which make it compulsory for all public entities, government departments and local government entities in South Africa to have internal audit activities.

The most important objective of the IIA-SA is to assist members. This is done through:

- technical support;
- courses, seminars and conferences;
- networking events;
- professional advice and guidance;
- technical products;
- quality assessment services;
- international benchmarking;
- accreditation;
- certification; and
- learnership programmes.

As a result of the requirements in respect of education and training in South Africa contained in the Skills Development Act, 97 of 1998, the IIA-SA registered a subsidiary company to address the provision of education and training services to members, namely, The Leadership Academy for Guardians of Governance. This was necessitated as the same organisation may not (by law) act as provider and assessor of education and training. The assessment function remained with the Institute. The restructuring was approved at an IIA-SA annual general meeting on 22 April 2015.

The IIA-SA introduced its first learnerships more than a decade ago. These learnerships form an integral part of the career pathway of internal auditors in South Africa.

Currently, two new qualifications, namely the internal auditor and internal audit manager are registered at the Quality Council for Trades and Occupations (QCTO) in terms of the Skills Development Act, 97 of 1998 and recognised on the National Qualifications Framework. These new qualifications underpin the IIA-SA designations of the Internal Audit Technician (IAT) and Professional Internal Auditor (PIA) respectively.

2.5 Legislation and codes

Various codes and legislation are relevant to the practice of internal auditing. The first prominent document for South African businesses addressing internal auditing was the first King Report on Corporate Governance (King I) issued on 29 November 1994. This report dealt with governance issues for South African companies. The report was issued after extensive research was done and guidance was obtained from similar reports such as the Cadbury Report issued in the United Kingdom and the COSO reports issued by the Treadway Commission in the USA. In 2002, the first King report was amended and an improved second version was issued. The third King report (King III) was issued in 2009, and highlights the critical role internal auditors play within the business environment. King III became effective as from March 2010 and is applicable to all types of organisations in the private and public sectors. In 2016, the fourth report (King IV) was issued with similar emphasis on internal auditing as in King III.

The King III report dedicates a separate chapter to internal auditing and describes the following five principles:

- the board should ensure that there is an effective risk-based internal audit activity;
- internal auditing should follow a risk-based approach to its internal audit plan;
- internal auditing should provide a written assessment of the effectiveness of the company's system of internal control and risk management;
- the audit committee should be responsible for overseeing internal auditing; and
- internal auditing should be strategically positioned to achieve its objectives.

King IV builds on the recommendations in King III and highlights the pivotal role of internal auditing in the combined assurance model as one of the key internal assurance providers. Furthermore, it is emphasised that the internal audit activity is an important pillar of organisational governance expected to add value, providing insight and foresight to a number of stakeholders.

The PFMA, issued in 1999, governs public entities, national governments and provincial governments. According to section 38 of the Act, a system of internal auditing under the control and direction of an audit committee must be established. The system should comply with and operate in accordance with the provisions of sections 76 and 77. Section 76 deals with general treasury matters, while section 77 prescribes the composition of an audit committee. The MFMA addresses the same issues as the PFMA, for local government entities.

The Sarbanes-Oxley Act (SOX), 2002 was issued in July 2002 in the USA, in response to corporate scandals such as Enron and WorldCom. The Act applies to all USA Securities Exchange Commission registrants, regardless of whether they are USA companies

or foreign private issuers. Although various sections of the Act refer to auditing and related matters, Section 404 incorporates internal control by requiring management to make an assessment of the effectiveness of internal control activities used by a company to account for and report financial information. In addition, this assessment must be audited and attested to by the external auditor. This Act played a major role in the global increase in demand for internal audit services.

In South Africa, the private sector followed suit and in 2005 the revision of the Companies Act, 61 of 1973, was tabled. The revised Companies Act, 71 of 2008 (the Companies Act) was issued and although the Act does not make the establishment of an internal audit activity compulsory, it does give backing to internal auditing by requiring an audit committee. The Companies Act recognises the existence of internal auditing as it commands audit committees to appropriately address any complaints received from the internal audit activity of the company.

2.6 Definition of internal auditing

The definition of internal auditing is one of the elements of the International Professional Practices Framework (IPPF). The IPPF is discussed in more detail in section 2.7. To fully understand the practice of internal auditing, it is important to investigate the changes that the definition has undergone to incorporate the developments in the internal audit profession.

One of the elements of the first Statement of Responsibilities of Internal Auditing accepted by the IIA was a formal definition of internal auditing, namely:

> Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation.

This definition led to the following Statement of Objective and Scope, issued in the same year:

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

The above definition focused mainly on the examination and evaluation of activities performed by the organisation; that is, compliance-testing regarding the business processes and informing management of weaknesses in the processes or non-adherence to policies and procedures implemented by management.

As business processes became more complicated, information more widely obtainable, and the corporate world in general more sophisticated, the need for the internal audit profession to adapt to this new environment became evident. In 1997, the IIA assembled a multinational group consisting of practitioners, academics and consultants, known as the Guidance Task Force (GTF), to study the needs of the profession. This group studied the internal audit profession from several perspectives, for example, the global profession, internal audit knowledge, and the future of the profession. The study concluded, amongst other things, that the then prevailing definition of internal auditing was insufficient to articulate the role of the modern internal auditor.

On 26 June 1999, the IIA board of directors approved the following revised definition of internal auditing:

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Table 2.1 provides a comparison of the key elements of this definition to those of the previous definition, emphasising the changes made. In this table, the consulting role of an internal auditor, as well as the fact that this role is based on assisting management to accomplish the organisation's objectives by identifying and managing threats, are highlighted. The original purpose of internal auditing was to provide assurance concerning historical activities in the organisation. Management's concept of internal auditing broadened over the years, leading internal auditors to also fulfil a consulting role. The current definition incorporates this added responsibility through the concept of consulting activities. Furthermore, there has been a shift from the original watchdog role to a more futuristic risk-based approach that is aimed at adding value.

In 2009, the PPF was revised (and its title changed to International Professional Practices Framework or IPPF) and the definition of internal auditing changed, placing the emphasis first on the role of the internal auditor on risk management processes, followed by internal control and governance processes (refer to the definition above). The IPPF was again revised in 2015 (as discussed in section 1.6), but the definition remained unchanged.

Table 2.1: Comparison of the previous and current definitions of internal auditing

Previous definition	Current definition
Independent appraisal function	Objective assurance and consulting activity
Established within an organisation	Independently managed within an organisation
Examines and evaluates its activities as a service to the organisation	Adds value to improve the operations of the organisation
Assists members of the organisation in the effective discharge of their responsibilities	Assists an organisation in accomplishing its objectives
Does analyses, appraisals; makes recommendations; provides counsel and information concerning the activities reviewed	Uses a systematic and disciplined approach
Promotes effective control at reasonable cost	Evaluates and improves the effectiveness of the organisation's risk management, control and governance processes

Source: A vision for the future: Professional Practices Framework for Internal Auditing (IIA 1999)

The current definition of internal auditing encompasses all the dimensions of the internal audit profession, suggesting a profession that is characterised by broad business parameters and technical skills. Internal auditors should understand business strategy. The definition envisions internal auditors who focus on adding value by facilitating change through advice and counsel, in some cases even providing assurance to parties outside the organisation, for example, trading partners.

This definition expands the scope of internal auditing to recognise its key role in governance and risk management, in addition to control activities. The definition of internal auditing was the first of a number of changes that have resulted in a review of the status of guidance provided to internal auditors. The definition has highlighted the wider responsibilities of internal auditing, for example, the consulting role, and therefore necessitated a revision of the current guidelines as embodied in the IPPF.

2.7 The International Professional Practices Framework

Structural guidance is needed to keep up with the dramatic changes in the business environment and hence to the internal audit profession. On 15 July 1947, the Statement of Responsibilities of Internal Auditors was approved by the IIA's board of directors. The purpose of this document was to establish a set of guidelines that defined the proper role and responsibilities of the internal audit activity. The scope of internal auditing has expanded, as highlighted in the revised definition of internal auditing, and the need for guidance that can be followed, regardless of the industry, audit speciality or sector, has increased. The current definition of internal auditing paved the way, and in June 1999 the IIA's board of directors approved a new set of guidelines, namely the PPF, which was revised in 2009 and the title changed to the International Professional Practices Framework (IPPF). The IPPF was revised again in 2015 and consists of the following two types of guidance:

- mandatory guidance (emphasised by the word "must"), consisting of:
  - the Core Principles of Internal Auditing;
  - the Definition of Internal Auditing;
  - the Code of Ethics; and
  - the *Standards*; and
- recommended guidance, comprising of:
  - implementation guidance (previously practice advisories); and
  - supplemental guidance (previously practice guides).

Underpinning the above-mentioned six elements of the IPPF is the Mission of Internal Audit. The Mission as well as the six IPPF elements (as illustrated in figure 2.1) are briefly discussed below.

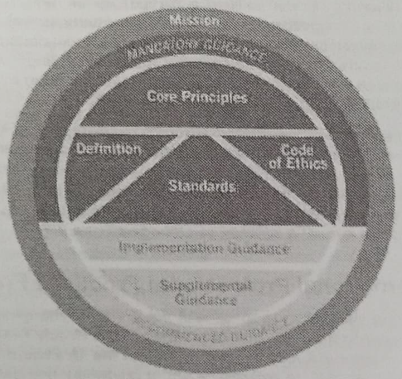

Figure 2.1: Framework for internal audit effectiveness: The new IPPF

Source: IIA, 2016

2.7.1 Mission of internal auditing

The mission statement of internal auditing articulates what internal audit aspires to accomplish within an organisation. Its place in the new IPPF is deliberate, demonstrating how practitioners should leverage the entire framework to facilitate their ability to achieve the mission.

> To enhance and protect organisational value by providing risk-based and objective assurance, advice, and insight.

2.7.2 Core Principles for the Professional Practice of Internal Auditing

The core principles underpin internal audit effectiveness. For an internal audit activity to be considered effective, all principles should be present and operating effectively. Although it is recognised that application of the core principles might differ between

organisations, internal auditors as well as internal audit activities should aspire to achievement. These core principles are: an effective internal audit

- Demonstrates integrity.
- Demonstrates competence and due professional care.
- Is objective and free from undue influence (independent).
- Aligns with the strategies, objectives, and risks of the organisation.
- Is appropriately positioned and adequately resourced.
- Demonstrates quality and continuous improvement.
- Communicates effectively.
- Provides risk-based assurance.
- Is insightful, proactive, and future-focused.
- Promotes organisational improvement.

2.7.3 Definition

The definition of internal auditing is the umbrella under which the rest of the elements of the IPPF fall. It has changed to incorporate the dynamic business environment and new challenges facing the internal audit profession.

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

2.7.4 Code of Ethics

A code of ethics was established to promote an ethical culture throughout the internal audit profession. The code applies to all internal auditors registered as members with the IIA who perform internal audit services, regardless of the industry and the changing business environment. The IIA Code of Ethics is presented in chapter 3.

2.7.5 International Standards for the Professional Practices of Internal Auditing

The International Standards for the Professional Practices of Internal Auditing (the *Standards*) are the minimum requirements which are internationally applicable at organisational and individual levels and provide a framework for performing and promoting internal auditing. The *Standards* consist of various criteria against which the activities of internal auditing are evaluated and measured. The *Standards* have been restructured to align these with the revised definition of internal auditing and now have a much broader perspective, prescribing a proactive role for internal auditors, not only in providing assurance services, but also consulting services. The *Standards* also include interpretations, which clarify terms and concepts within the statements and are discussed in detail below.

The purpose of the *Standards* is to:

- delineate basic principles that represent the practice of internal auditing, as it should be;
- provide a framework for performing and promoting a broad range of value-added internal audit activities;
- establish the basis for the evaluation of internal audit performance; and
- foster improved organisational processes and operations.

The *Standards* consist of various elements as illustrated in figure 2.2. Attribute standards (the 1000 series) and performance standards (the 2000 series) form the basis of these *Standards* (see table 2.2 for a summary of the content of these *Standards*). The attribute standards focus on the characteristics and qualities of the internal audit activity as well as on the individuals who perform the services of the activity. In chapter 3, the professionalism of the internal auditor and internal audit activity are introduced and the attribute standards are discussed in this context. These standards are addressed in the 1000 series of the *Standards*. The performance standards focus on internal audit services and the internal audit process, as well as the measurement of the quality thereof. These comprise the 2000 series of the *Standards*. These standards are introduced throughout the remainder of the textbook, were applicable.

The implementation standards apply the attribute and performance standards to various types of services rendered, such as assurance engagements, fraud investigation and reviews. Various sets of implementation standards exist and more are to be developed. The implementation standards are currently divided into assurance implementation standards and consulting implementation standards. The assurance implementation standards are represented by the A series, for example A1, while consulting implementation standards are represented by the C series, for example C1.

Assurance standards deal with the objective evaluation of evidence to provide an independent assessment of governance, risk management and control processes. According to the IIA, "governance" refers to the processes, procedures and structures implemented by the board to inform, direct, manage and monitor the activities of the organisation toward the achievement of objectives. "Risk management" is the process that management puts into operation to address risk and mitigating the risks to an acceptable level. "Risk" refers to the uncertainty that an event could occur that could have a negative impact on the achievement of objectives. "Control" refers to actions taken by management, the board or other parties to manage risk and enhance the achievement of organisational objectives and goals. Usually three parties are involved in assurance services, namely the person or group involved with the process (process owner), the person or group making the assessment (the auditor), and the person or group using the assessment to make decisions (the user, for example management).

Consulting standards focus on consulting services, which are activities beyond traditional assurance work, as requested by management, to assist them to achieve the organisation's objectives. They are advisory and other non-assurance activities delivered by the internal auditor based on a specific request by an engagement client. Consulting services involve two parties, namely the client and the auditor. It is important to note that when performing consulting services, the internal auditor should maintain objectivity and not assume management responsibility.

Unlike assurance services where the internal auditor determines the scope and nature of the engagement, in consulting services these are subject to agreement with the client. Both must add value, improve the organisation's governance, risk management and control processes.

It is important to note that the implementation standards have currently been developed for assurance and consulting services. These standards may ultimately also distinguish between industry-specific, regional and speciality audit services.

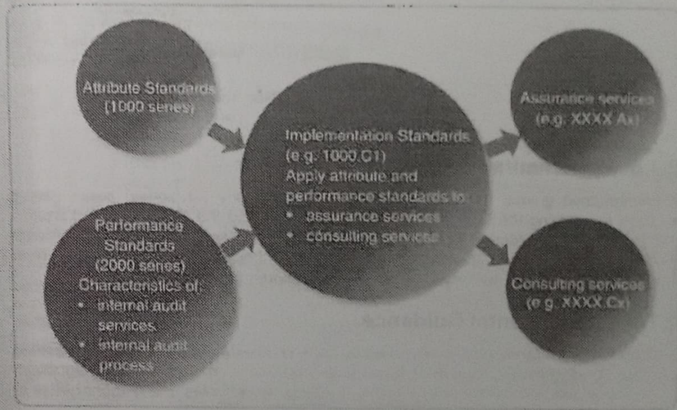

Figure 2.2: Interrelations of the *Standards*

Table 2.2: Summary of the *Standards*

Attribute Standards Characteristics of the Internal Audit Activity and the Internal Auditor (1000 series)	Performance Standards Internal Audit Services (2000 series)
1000 Purpose, authority and responsibility	**2000** Managing the internal audit activity
1100 Independence and objectivity	**2100** Nature of the work
1200 Proficiency and due professional care	**2200** Engagement planning
1300 Quality assurance and improvement programme	**2300** Performing the engagement
	2400 Communicating results
	2500 Monitoring progress
	2600 Resolution of management's acceptance of risks

2.7.6 Implementation Guidance

Implementation guides (previously referred to as practice advisories) assist internal auditors in applying the Definition, the Code of Ethics and the *Standards*, and promoting good practices. Internal auditors have the option to adhere to these implementation guides, which are not compulsory like the *Standards*. Implementation guides are, however, very useful as an interpretation tool for the *Standards*.

2.7.7 Supplemental Guidance

Supplemental guidance (previously practice guides) assists a wide range of interested parties, including those not in the internal audit profession, in understanding significant governance, risk and control issues and delineating related roles and responsibilities of internal auditing.

These guidelines consist of educational products, research studies and other relevant material. These guides are not mandatory, but could help internal auditors to assist management with governance, risk management and control processes relevant to the organisation. Position papers (providing guidance as well as advocating the profession) are excluded from the new IPPF. Where applicable, existing position papers providing specific guidance on the implementation of the *Standards*, will be incorporated into the implementation guidance.

The IPPF is intended to encourage quality internal audit services on a consistent basis worldwide and to guide internal auditors, management and audit committees. It is the internal auditor's task to operate within a professional framework to assist the organisation in achieving the highest quality results and its long-term objectives.

2.8 The role of internal auditing in the business environment

In order for organisations to meet their strategic objectives, internal auditors need to make meaningful contributions with regard to governance, risk management and control processes and operations. As indicated in the definition of internal auditing, internal auditors are expected to add value by advising management regarding governance, risk and control processes. An effective internal audit activity should be at the centre of every organisation and be respected for the role it plays. The internal audit activity must have the full co-operation and support of the board of directors and management in order to be really effective. To enhance the effectiveness of the internal audit activity, and to ensure its independence, internal auditors should report to the highest level of authority in the organisation.

The comprehensive scope of internal auditing should provide reasonable assurance that the organisation's:

- governance processes are adequate and effective, by establishing and preserving values, setting goals, monitoring activities and performance, and defining the measures of accountability;
- risk management processes are adequate and effective; and
- control processes are adequate and effective.

According to the definition of internal auditing, the internal audit activity provides a variety of services to the management of an organisation that includes assurance and consulting services. Assurance services are the examination of evidence by the internal auditor to provide an independent and objective opinion on:

- whether management's policies and procedures are adhered to;
- whether processes (including control activities) are mitigating the risks threatening management's objectives; and/or
- whether the organisation is adhering to/complying with relevant laws and regulations.

Consulting services include activities such as:

- conducting staff training;
- providing advice to management on controls, risk issues and governance;
- assisting in developing and drafting policies, and
- participating in quality teams.

There are numerous reasons why organisations should have an internal audit activity. Consider the following important functions of the internal audit activity:

- The internal auditor assists management to comply with its responsibilities of financial control and reporting. It is the responsibility of the management of an organisation to apply sound accounting policies, to maintain an effective and adequate accounting system, to safeguard the assets of the organisation and to establish and maintain an internal control structure which will ensure the drafting of proper financial statements. The internal auditor assists management to fulfil this important responsibility. As management possibly will not possess all the necessary knowledge, the internal auditor can advise it on important matters. Table 2.3 provides a few examples of how internal auditors have assisted management in the past and how this has resulted in savings for the organisation.

Table 2.3: Some examples of the value added to organisations by internal auditors

Management decided to significantly change one of the organisation's large product lines. The product had to be re-designed and new parts had to be purchased to replace the old ones. Whilst conducting an audit engagement on changes in product lines, the internal auditors discovered that the purchasing agents switched to ordering the new parts, but nobody had informed them to stop ordering the old parts. These parts were obsolete and could not be used any longer. The internal auditors notified management, who immediately issued instructions to cancel all orders for the old parts.
A number of orders were not delivered on time and were overlooked by the production department. The organisation thought it was due to people not doing their jobs, but the actual cause was that management failed to establish a central log to keep track of all the incoming orders. It failed to number the orders in order to determine the priority of orders. The internal auditors helped them to realise the inadequacy of the internal control activities.
An excessive number of returns of manufactured goods were received by a production department. On the surface, the reason seemed to be inadequate quality inspections before the goods left the premises. The actual cause was that the quality manager reported to the director of production, who was only interested in reducing costs and staying on schedule. He therefore overruled any concerns that the manager had. The internal auditors helped them get to the root of the problem.
A large mining group's internal auditors discovered that the concrete slabs that were used in construction were five centimetres thicker than indicated by the specifications. This was discussed with management and money was saved, since tons of cement were no longer needed.
A change in the design of containers in which products are transported by rail meant that more containers could be fitted into a single railway truck and resulted in a saving on transport costs. This consideration of the economical and effective use of resources is one of the important tasks of the internal auditor.
Just as managers need the services of attorneys, investment advisors, insurance brokers and security experts, the services of the internal auditor are also needed by management. Not all managers possess the necessary expertise with regard to management techniques and administrative matters, and a management-oriented internal auditor can, with expert advice, assist with the training of such personnel.

continued

Sources: *The Practice of Modern Internal Auditing* by Lawrence Sawyer and *Internal Auditing Principles and Practices* by Richard Ratcliff

- According to the agency theory, the owners (shareholders for private sector and general public for government) and the managers of the organisation (board of directors for the private sector and Parliament for government) are different persons. The owners (principal) entrust their business to a manager (agent). The agent must report, using the financial statements, to the owner. To give the necessary assurance to the owner, external auditors are appointed to conduct independent and objective audits. The internal auditor assists management by adding value and improving the organisation's operations. The mere fact that an internal audit activity exists within an organisation adds value to the agency theory, as this keeps personnel on their toes. If the internal audit activity is effective, this fact enhances the theory even more. Both the internal and external auditors perform an important role in the agency theory.

Modem organisations are under enormous competitive pressures in the market. They have to reach their objectives utilising limited resources. The internal audit activity is a resource within the organisation that can add value and assist management to operate more economically, efficiently and effectively.

Class discussion 1

Internal auditor X is a newly appointed internal auditor and is requested to prepare a presentation on the structure and content of the *Standards* to the rest of the internal audit team.

Address the following aspects in the presentation:

- the difference between assurance and consulting services;
- the difference between attribute and performance standards;
- the link between assurance/consulting services and attribute/performance standards;
- the content of the *Standards;* and
- the link between the definition of internal auditing and the *Standards.*

2.9 Summary

This chapter introduces the internal audit profession, the role of the Institute of Internal Auditors (IIA), and the role of internal auditors. The International Professional Practices Framework (IPPF), including the structure of the *Standards* are discussed.

Internal auditors provide a wide range of assurance and consulting services. The organisation and all its stakeholders expect the internal audit activity to add value by providing objective and relevant assurance and contributing to the effectiveness and efficiency of governance, risk management and control processes.

2.10 Siyafunda Limited

The board of Siyafunda Ltd recently made a decision to establish an in-house internal audit activity. They appointed Greg Grey as the chief audit executive (CAE), the head of the internal audit activity who will manage the services rendered by the internal audit activity to the organisation. Greg is a member of the Institute of Internal Auditors (IIA). A few months after Greg's appointment, three senior internal auditors and two internal auditors were appointed to the internal audit activity. The board asked Greg to make a presentation at the next board meeting to explain, amongst others, the role and responsibilities of the internal audit activity.

You are required to:

Prepare draft notes that can be used by the CAE to explain the following internal audit related issues:

1. The motivation for establishing an internal audit activity.
2. The role of an internal audit activity, with reference to the definition of internal auditing.
3. The role of the Institute of Internal Auditors (IIA).
4. The purpose of the International Professional Practices Framework (IPPF) and a brief description of each of its elements.

The Professional Internal Auditor 3

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