INTERNAL AUDITING – A MANAGEMENT FUNCTION

By GEORGE STROH,
Chief Internal Auditor, Iscor

HISTORICAL DEVELOPMENT

THE internal auditor first gained recognition as a checker of financial information and arithmetical accuracy, and as a verifier of cash and other assets and acted as a general supplement to the external audit function. One of his major functions was to investigate fraud, defalcation and cases where the organisation had lost money through gross negligence, etc.

It soon became obvious that much time and effort could be saved if the internal auditor, as part of his normal function, could insist on proper and economic controls being instituted in the line functions.

Controls or controlling entails more than a mere recording function or a check on people; it also includes a measurement function and serves as a check on progress against a predetermined plan. Controlling includes the provision of reports to management which highlight the exception and trend but which do not reflect the routine or detail. Controlling also includes the provision of timely submission of these reports to management to enable them to plan remedial action and to prevent recurrence of unsatisfactory conditions through anticipation before the consequences are too serious. Controlling further provides for timely feed-back to management on the effect of any decision taken.

The institution of proper controls had a dual effect, viz. (1) management information became more reliable, and (2) the likelihood of the organisation losing money through fraud or negligence was radically reduced.

The initial success prompted the internal auditor to delve deeper into systems and procedures and the linking of procedures and responsibilities between units of the organisation. Through these investigations the internal auditor gained an excellent knowledge of the various phases of the organisation.

The internal auditor, having gained the confidence of the various functionaries and a full understanding of the relationship of any unit to others in the organisation and with his intimate knowledge of policies, procedures, control features, various operations and abilities of individuals, and not being debarred from any source, information or data, has moved a long way to being able to render a useful management service. In making the internal auditor functionally responsible to an official of sufficiently high rank, and giving him the authority to review any operation in which he can be of service to management — without fear that he might prejudice his own advancement — he has gained the independence, of the functions that he is reviewing, which enables him render an objective appraisal activity of all facets in an organisation with a view to optimisation.

Top management, and even the functional managers in the explosive growth, diversification of enterprise and the trend towards decentralisation found themselves further and further removed from the actual day-to-day operations. It became physically impossible to supervise personally and evaluate objectively, the effectiveness and efficiency of the functional operations under their control. To a great extent they also had to rely on information generated in units not under their control, and frequently important management decisions had to be based on a combination of information generated in various units, the validity of each piece of information being vital for correct and timely decisions.

In numerous enterprises these developments coincided, and at a stage when management needed an objective appraisal activity, the internal audit function had been developed and had gained enough experience and an intimate knowledge of operations to enable it to render this service.

The above historical review merely indicates that the internal audit function was created to fulfil a management need and that this function should be extremely perceptible to changing management needs.

Only whilst it can render this unbiased and objective appraisal service to management is its existence warranted.

The development of the internal audit function in the United States of America in general has advanced much further along the lines indicated than is the case in the Republic of South Africa; the main reason being the size of enterprises in the U.S.A. and the corresponding need for an objective independent appraisal.

INSTITUTE OF INTERNAL AUDITORS

The Institute of Internal Auditors was founded during November, 1941, and in its latest statement on Internal Auditing (1957) the broader concept is clearly indicated.

Nature of Internal Auditing:
Internal auditing is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.

Objective and Scope of Internal Auditing:
The overall objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor therefore should be concerned with any phase of business activity wherein he can be of service to management. The attainment of this overall objective of service to management should involve such activities as:

- *Reviewing and appraising the soundness, adequacy and application of accounting, financial and operating controls.*
- *Ascertaining the extent of compliance with established policies, plans and procedures.*
- *Ascertaining the extent to which company assets are accounted for, and safeguarded from losses of all kinds.*
- *Ascertaining the reliability of accounting and other data developed within the organization.*
- *Appraising the quality of performance in carrying out assigned responsibilities.*

The spirit of this statement indicates that the internal auditor should not exercise direct authority over persons whose work he reviews, and, simultaneously, his evaluation and appraisal activity should not in any way relieve other persons in the organisation of the responsibilities assigned to them. The internal audit function by its nature could therefore not be a line function and the internal auditor should not be responsible for developing and installing procedures and preparing records or for any line activity which he may later be called upon to evaluate. This will impair his independence and objectivity and he must therefore render his management service from a staff position.

THE PRIVATE PRACTISING AUDITOR AND THE INTERNAL AUDITOR

Confusion also exists as to the responsibilities of the independent auditor and those of the internal auditor. Although there is great similarity in the fields they cover and in their approaches in the financial field, a summary of the principal differences will help to maintain a clear distinction between the two types of activities.

1. Responsibility:

An independent audit is performed by a private practitioner.

An internal audit is performed by a company employee.

2. Functional Responsibility:

The independent auditor is primarily responsible to the shareholders by whom he is appointed, but third parties also rely heavily on the report brought out on final accounts. He should be independent of management, both in fact and in mental attitude.

The internal auditor is concerned in serving the needs of management. He should be independent of the treasurer and chief accountant but subservient to all other needs and desires of management.

3. Objectives:

The independent audit review is made primarily to determine the scope and the reliability of financial data, and the work is planned in such a manner that principal balance sheet and income and expenditure statement items are verified individually.

The internal audit review is made to induce compliance with established policies, procedures, etc., and to develop improvements and recommend changes to existing systems, procedures, etc., where wasteful and costly procedures are still adopted. The work is sub-divided primarily according to operating functions and lines of management responsibility and are aimed at optimisation in each function.

4. Fraud Detection:

Except in so far as the financial statements may be seriously affected, the independent auditor is only incidentally concerned with the detection and prevention of fraud.

The internal auditor is directly concerned with the prevention and detection of fraud.

4. Statutory Requirements:

In South Africa the independent auditor is bound by statute to certain minimum procedures in the presentation of accounts.

The internal auditor is also responsible for ensuring that all statutory requirements are met, even in the detailed applications, e.g. wages and salary agreements, workmen's compensation, hospitalisation facilities and security measures (explosives, cash, etc.).

It is obvious then that, although much of the work done by the internal auditor still supplements the external audit function, the prime objective is not to save on external audit fees but to render a management service to management.

THE INTERNAL AUDIT FUNCTION

The appraising and evaluating function performed by the internal auditor must be critical and should be aimed at eliminating all ineffective and/or costly systems, procedures or policies, duplication of effort and at indicating omissions, inadequate training, inefficiency, etc. Although critical in his examination, the internal auditor must always bear in mind that his criticism must be constructive and have the ultimate aim of improving — in the strictest sense — the competitive edge of the organisation. In his review the internal auditor should intelligently scrutinise all information available, efficiency of works performance, proper delegation of authority, proper acceptance of responsibilities, whether performances are carried out in accordance with and within the framework of specific job descriptions and whether there are certain scientifically calculated standards against which performance can be measured. Through this scrutiny he must ascertain whether management is fully informed on an exception basis of each facet of the operation.

The internal auditor must not be afraid to ask questions and by asking his why? when? how? to whom? by whom? etc., questions, must acquaint himself with all aspects of the operation.

Although the internal auditor is expected to accentuate weaknesses, malfunctions, inefficiencies, etc., it is also his duty to accentuate exceptionally strong points, outstanding performances, etc. Only if the internal auditor adopts this approach does he fully serve the line managers and will he gain their full confidence.

It has been said that the internal auditor is paid to know . . . not to guess. Once the internal auditor has reviewed any operation, the whole of the operation, together with the reasons for each specific step, should be 100% clear to him, and moreover he should fully understand and agree with the reasons why it is done in that specific way and not in any other. Only if he approaches his assigned task in this methodical way can be achieve the optimum results for the benefit of management.

In order to serve management the auditor must, from the manager's viewpoint, ask himself the following questions:

1. What information would I require?
2. Why should I require this information?
3. How often would I require this information?
4. At what stage would I require this information?
5. In what detail would I require this information?
6. Would exception reporting suffice?
7. In which format and layout would I require this information?
8. Would this information give me a full picture of the facts, trends, measurement and projection to enable me to discharge my management function?

Through an intelligent scrutiny of all relevant records and other information and of the reports generated by it, the internal auditor is to ascertain that the manager has in actual fact received all the planned information in good time and consistent with previous information.

Optimisation is by far the most important objective of the internal auditor. Although he is vitally concerned with fairness of presentation within the strict boundaries of statute and case law, the mere fact that he is always striving for improved operations from which the whole organisation will ultimately benefit financially, these minimum standards are really only yardsticks against which to measure present performance, and the higher the performance the more commendable the high "gain" variance.