

# **CHAPTER 1**

## **INTERNAL AUDITING: HISTORY, EVOLUTION, AND PROSPECTS**

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The Professional Practices Framework for Internal Auditing (PPF) was designed by The IIA Board of Directors' Guidance Task Force to appropriately organize the full range of existing and developing practice guidance for the profession. Based on the definition of internal auditing, the PPF comprises *Ethics* and *Standards*, *Practice Advisories*, and *Development and Practice Aids*, and paves the way to world-class internal auditing.

This guidance fits into the Framework under the heading *Development and Practice Aids*.

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## I. Background

The establishment, growth, and evolution of the contemporary internal auditing profession is closely intertwined with the history of The Institute of Internal Auditors (IIA), an organization founded in the United States in 1941. In the recently released edition of *60 Years of Progress Through Sharing*, chronicling the history of The IIA, internal auditing historian Dale L. Flesher notes:

“The IIA’s 60-year history is illustrious and each of the highlights featured in this 10-year narration [supplementing the 50-year history of The IIA] have contributed to the organization that The IIA is today:

- The primary international professional association dedicated to the promotion and development of the practice of internal auditing.
- The recognized authority, chief educator, and acknowledged leader in standards, certification, research, and technological guidance for the profession worldwide.
- Global headquarters for 76,400 members in 141 countries.” (Flesher & McIntosh, 2002, ix)

Considering The IIA’s rather humble origins — a small band of 24 charter members who held the inaugural IIA meeting in New York City<sup>1</sup> on December 9, 1941 — this worldwide expansion, continuing relevance, and increasing influence and recognition of The IIA and the internal auditing profession over the last 60 years constitutes remarkable growth and progress. Indeed, the internal auditing profession certainly appears poised for continued dynamic growth and promises to become “a profession for the 21<sup>st</sup> century.”<sup>2</sup>

## II. Internal Auditing: An Historical Perspective

The demand for both external and internal auditing is sourced in the need to have some means of independent verification to reduce record-keeping errors, asset misappropriation, and fraud within business and nonbusiness organizations. The roots of auditing, in general, are intuitively described by accounting historian Richard Brown (1905, quoted in Mautz & Sharaf, 1961) as follows:

“The origin of auditing goes back to times scarcely less remote than that of accounting...Whenever the advance of civilization brought about the necessity of one man being intrusted to some extent with the property of another, the advisability of some kind of check upon the fidelity of the former would become apparent.”

As far back as 4000 B.C., historians believe, formal record-keeping systems were first instituted by organized businesses and governments in the Near East to allay their concerns about correctly accounting for receipts and disbursements and collecting taxes. Similar developments occurred with respect to the Zhao dynasty in China (1122-256 B.C.). The need for and indications of audits can be traced back to public finance systems in Babylonia, Greece, the Roman Empire, the City States of Italy, etc., all of which developed a detailed system of checks and counterchecks. Specifically, these governments were worried about incompetent officials prone to making bookkeeping errors and inaccuracies as well as corrupt officials who were motivated to perpetrate fraud whenever the opportunity arose. Even the Bible (referring to the period between 1800 B.C. and A.D. 95) explains the basic rationale for instituting controls rather straightforwardly: "...if employees have an opportunity to steal they may take advantage of it." The Bible also contains examples of internal controls such as the dangers of dual custody of assets, the need for competent and honest employees, restricted access, and segregation of duties (O'Reilly et al., 1998). Historically then, the emergence of double-entry bookkeeping in circa 1494 A.D. can be directly traced to the critical need for exercising stewardship and control. Throughout European history, for instance, fraud cases — such as the South Sea bubble of the 18th century, and the tulip scandal — provided the justification for exercising more control over managers.

Within a span of a couple of centuries, the European systems of bookkeeping and auditing were introduced into the United States. As business activities grew in size, scope, and complexity, a critical need for a separate internal assurance function that would verify the (accounting) information used for decision-making by management emerged. Management needed some means of evaluating not only the efficiency of work performed for the business but also the honesty of its employees. Around the turn of the 20<sup>th</sup> century, the establishment of a formal internal audit function to which these responsibilities could be delegated was seen as the logical answer. In due course, the internal audit function became responsible for "careful collection and interpretive reporting of selected business facts" to enable management to keep track of significant business developments, activities, and results from diverse and voluminous transactions (Mautz, 1964). Companies in the railroad,<sup>3</sup> defense, and retail industries had long recognized the value of internal audit services, going far beyond financial statement auditing and devoted to furnishing reliable operating reports containing nonfinancial data such as "quantities of parts in short supply, adherence to schedules, and quality of the product" (Whittington & Pany, 1998). Similarly, the U.S. General Accounting Office (GAO) and numerous State Auditors' Offices, for instance, the State of Ohio Auditors' Office, have traditionally employed large numbers of internal auditors.

In sum, the collective effect of growing transaction complexity and volume, the owner/manager's ("principals") remoteness from the source of transactions and potential bias of

reporting parties (“agents”), technical (accounting) expertise required to review and summarize business activities in a meaningful way, need for organizational status to ensure independence and objectivity, as well as the procedural discipline necessary for being the “eyes and ears” of management all contributed to the creation of an internal audit department within business organizations. Starting as an internal business function primarily focused on protection against payroll fraud, loss of cash, and other assets, internal audit’s scope was quickly extended to the verification of almost all financial transactions, and still later, gradually moved from an “audit for management” emphasis to an “audit of management” approach<sup>4</sup> (Reeve, 1986).

The critical importance and relevance of internal auditing to business, as well as the *raison d’être* for the establishment of The Institute of Internal Auditors in the United States, can best be gauged from the following visionary and prescient remarks by two of The IIA’s charter members (quoted in Flesher, 1996, pp. 1, 3):

“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 or later, and, if events keep developing as they do at present, they will have to have it sooner.” (Arthur E. Hald, 1944)

“The Institute is the outgrowth of the belief on the part of internal auditors that an organization was needed in the structure of American business to develop the true professional status of internal auditing...Although its roots are in accountancy, its key purpose lies in the area of management control. It comprises a complete intracompany financial and operational review.” (Robert B. Milne, 1945)

Nevertheless, in the early years after The IIA was established, internal auditing was still perceived as a closely related extension of the work of external auditors — they were frequently called upon to assist external auditors in financial statement reviews or perform accounting-related functions such as bank reconciliations. Internal auditors were seen to be playing a fairly modest role within organizations and had only a “limited responsibility in the total managerial spectrum” (Moeller & Witt, 1999).

Almost two decades after the founding of The IIA, the following definition of internal auditing, laying the ground for an “operational auditing” orientation,<sup>5</sup> was presented by Brink and Cashin (1958):

“Internal auditing thus emerges as a special segment of the broad field of accounting, utilizing the basic techniques and method of auditing. The fact that the public

accountant and the internal auditor use many of the same techniques often leads to a mistaken assumption that there is little difference in the work or in ultimate objectives. The internal auditor, like any auditor, is concerned with the investigation of the validity of representations, but in his case the representations with which he is concerned cover a much wider range and have to do with many matters where the relationship to the accounts is often somewhat remote. In addition, the internal auditor, being a company man, has a more vital interest in all types of company operations and is quite naturally more deeply interested in helping to make those operations as profitable as possible. Thus, to a greater extent, management services comes to influence his thinking and general approach.”

Soon thereafter, the National Industrial Conference Board underscored the importance of internal auditing thus (Walsh, 1963):

“The widening gap between management and action has made it necessary to develop a series of controls by means of which the business may be administered efficiently. The internal auditor perfects and completes each of these activities by providing on-the-scene appraisal of each form of control. There is no known substitute for this activity.”

With respect to professional standards and professional responsibilities, the two most influential individuals in The IIA’s history were arguably Victor Z. Brink and Lawrence B. Sawyer,<sup>6</sup> respectively. Already introduced as a pioneering figure in 20<sup>th</sup> century internal auditing, Victor Z. Brink, as The IIA’s first research director, was instrumental in getting The IIA’s *Statement of Responsibilities of the Internal Auditor* issued in 1947. The *Statement of Responsibilities of the Internal Auditor* clarified that while internal auditing primarily dealt with accounting and financial matters, matters of an operating nature also lay within its scope of activities. By 1957, the *Statement of Responsibilities of Internal Auditing* had been considerably broadened to include numerous services to management, such as:

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

Subsequently, in 1971, as chairman of the Research Committee, Lawrence Sawyer assumed the task of successfully revising the *Statement of Responsibilities*. The *Statement of Responsibilities* underwent further revisions in 1976, 1981, and 1990 to reflect the continuing and rapid evolution of the internal auditing profession.

In 1978, The IIA formally approved the *Standards for the Professional Practice of Internal Auditing (Standards)*, which had the following purposes:

- “1. Assist in communicating to others the role, scope, performance, and objectives of internal auditing.
2. Unify internal auditing throughout the world.
3. Encourage improved internal auditing.
4. Establish basis for consistent measurement of internal auditing operations.
5. Provide a vehicle by which internal auditing can be fully recognized as a profession.”

The *Standards* contained the following definition and objective of internal auditing:

“Internal auditing is an independent appraisal activity established within an organization as a service to the organization. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls. The objective of internal auditing is to assist members of the organization 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 *Standards* also laid out the criteria, using which, internal audit department operations should be evaluated and measured. They covered various aspects of internal auditing within organizations such as independence, professional proficiency, scope of work, performance of audit work, and management of the internal audit department. *Standards* interpretations were enshrined in *Statements on Internal Auditing Standards (SIAS)*; some examples of these were specific SIAS focusing on control concepts, risk assessment, preventing and investigating fraud, relationships with independent auditors, communication with board of directors, assignment planning, and follow-up on audit findings.

By this time, in terms of planning, fieldwork, and reporting, the basic steps in an operational audit had been sequenced as follows: perform a preliminary survey; develop the audit program; perform the fieldwork; prepare the working papers; develop a list of, and prioritize, audit

findings; discuss findings with the auditee; and, finally, prepare and present the audit report. The *Standards* and the SIAS served as the measures of the quality of performance of internal audit work engagements.

There was no doubt that, by the late 1970s, the field of internal auditing had earned the right to be called a “full-fledged profession,” even using James Carey’s (1969) seven, fairly stringent qualifying conditions for a “profession.” Sometime after 1974, when the Certified Internal Auditor (CIA) exam was sponsored by The IIA, internal auditing had a sufficiently respectable profile and merited being called an established profession because: it had a body of specialized knowledge (common body of knowledge approved in 1972), a formal educational process (a minimum prescribed course of formal education), standards governing admission as a full member of The IIA (prescribed course of study, passing CIA exam, professional experience requirements, and the *Standards*), a Code of Ethics (first approved in 1968), a recognized status indicated by a license or special designation (the CIA, or the MIIA<sup>7</sup>, recognized in several jurisdictions worldwide), a public interest in the work that the practitioners perform (perhaps more evident in the work performed by internal auditors in government, education, and nonprofit organizations rather than in the private sector), and a recognition by professionals of a social obligation (again, perhaps more evident in government, education, and nonprofit organizations).

For the internal audit function to raise its organizational stature, it was critical that it forge a strong relationship with “those charged with organizational governance,” and communicate directly to the audit committee. There is much evidence today that such a reporting relationship is being widely viewed as a best practice in the most progressive corporations committed to enhancing governance structure and processes. In an early but landmark study on corporate audit committees, Mautz & Neumann (1977) stated:

“For the most part the audit committee is viewed as a bridge between the board of directors and the auditors...To fulfill their responsibilities to shareholders and the public at large, audit committee members have had to become more interested in, and better informed on, auditing matters. Management also has become aware of the necessity of protecting itself through adequate attention to internal controls and effective audits. Consequently, it has become more responsive to auditor suggestions and audit committee requests for information.”

In similar vein, authors Brink & Witt (1982) noted that:

“In most situations the internal auditing group has moved to very high levels in all operational areas and has established itself as a valued and respected part of the top



management effort. To an increasing extent also the internal auditor is serving the board of directors — usually via the audit committee of that board.”

By 1993, the *Statement of Responsibilities of Internal Auditing* noted that “the scope of internal auditing encompasses the examination and evaluation of the adequacy and effectiveness of the organization’s system of internal control and the quality of performance in carrying out assigned responsibilities.” At this time, the scope of internal auditing included:

1. Reviewing the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
2. Reviewing the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations that could have a significant impact on operations and reports, and determining whether the organization is in compliance.
3. Reviewing the means of safeguarding assets and, as appropriate, verifying the existence of such assets.
4. Appraising the economy and efficiency with which resources are employed.
5. Reviewing operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.”

It was well-understood by the early 1990s that internal auditors, depending on their particular organization’s needs and preferences, worked in several areas: compliance audits, audits of transaction cycles, investigating fraud and other irregularities, evaluating operational efficiency, analysis, measurement and reporting of operational and organization-wide risks, and other assurance and consulting activities. They performed a combination of *financial* reviews and audits, *operational* reviews and audits (sometimes called *program audits*, *performance audits*, *comprehensive audits*, and other similar descriptive labels), *management* audits, and *compliance* audits. In performing many of these activities, internal auditors made their approach risk-based and controls-focused. They also made extensive use of sophisticated technology applications in carrying out audits.

Gradually, internal auditors also began to exhibit “industry specialization” in terms of their domain knowledge of specific industries such as health care, oil, gas, and energy, defense, financial services, transportation, wholesale and retail, technology, telecommunications, media and entertainment, government and nonprofits, education, etc. Internal audit staff began to come from diverse backgrounds, including a large proportion of non-accounting majors, and women gained prominence within the profession. Internal auditors also became much more internationally oriented. In many cases, internal auditing became rather opportunistic, and internal auditors began to participate in and contribute to “special projects” on a

contingency basis, whether performing the role of risk officers, ethics officers, or compliance officers, as the situation demanded.

### **III. Contemporary Practice of Internal Auditing: Environmental Changes, New Roles and Responsibilities, New Definition**

As the internal auditing profession became more firmly established, it responded quickly to new demands from significant regulatory and legislative mandates, as well as high-profile (inter)national reports: the passage of the Foreign Corrupt Practices Act (1977), particularly its emphasis on internal controls; the issuance of the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission Report, 1987); the Report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (COSO, 1992); as well as the subsequent internal control frameworks presented by the Cadbury Committee Report (Cadbury Report, UK); the Criteria of Control Committee (CoCo Report, Canada); and the King Committee (King Report, South Africa); the amendments to the U.S. Federal Sentencing Guidelines (1995); recent changes in the New York Stock Exchange rules regarding the structure and composition of the Board of Directors of listed companies as well as the requirement for all publicly listed companies to have an internal audit function;<sup>8</sup> the newly passed Sarbanes-Oxley Act of 2002; and ongoing calls for better organizational governance.

The business environment has experienced rapid and revolutionary change with far reaching consequences for organizations worldwide. Management responses to fierce global competition have included improved quality and risk management initiatives, reengineered structures and processes, and greater accountability — all needing more timely, reliable, and relevant information for decision-making. Organizations are also scrambling to put in place more effective governance structures and processes. In such a climate, it is no surprise that the internal audit function is viewed as the most qualified group of professionals to help with such experimentation with improved governance as well as support key governance processes: for monitoring the controls over, and for evaluating the operational effectiveness of, these management strategies and initiatives. However, to take advantage of this tremendous surge in the demand for their services, not only do internal auditors need a considerably enhanced repertoire of skills, attributes, and competencies but they also need to commensurately raise their organizational status and profile and align themselves appropriately within their respective organizations.

Ratliff & Reding (2002, p. xi) capture the expanded responsibilities and skill-set of the 21<sup>st</sup> century auditor as follows:

“Auditors of the 21<sup>st</sup> century must be prepared to ‘audit’ virtually everything — operations (including control systems), performance, information and information systems, legal compliance, financial statements, fraud, environmental reporting and performance, and quality. Auditors must master:

- Analytical and critical thinking skills.
- An efficient method to gain an adequate understanding of any auditee — individual, organization, or system.
- New concepts, principles, and techniques of internal control.
- An awareness and understanding of risk and opportunity related to both the auditee and the auditors.
- Development of general and specific audit objectives for any audit project.
- Selection, collection (using a broad array of audit procedures), evaluation, and documentation of audit evidence, including the use of statistical and non-statistical induction.
- Reporting audit results in a variety of formats to a variety of recipients.
- Audit follow-up.
- Professional ethics.
- Audit technology applicable across a variety of types of audit reports.

In addition, auditors must understand the concepts of auditor independence and objectivity as these concepts relate to different types of audits by different types of auditors. They must fully understand cost and materiality implications of risk, opportunity, and audit evidence.”

In similar vein, Moeller & Witt (1999, p. 14-15) list the following necessary personal attributes to be a successful internal auditor (in addition to technical and professional qualifications, this is a formidable list): (1) basic fairness and integrity; (2) dedication to the organization’s interests; (3) reasonable humility; (4) professional poise; (5) empathy; (6) role consistency; (7) curiosity; (8) critical attitude; (9) alertness; (10) persistence; (11) energy; (12) self-confidence; (13) courage; and (14) ability to make sound judgments.

The new roles, responsibilities, and attributes of the contemporary internal auditor envisaged by these authors constitute a tall order. It is to understand these elements better that The IIA Research Foundation sponsored the wide-ranging, three-volume *Competency Framework for Internal Auditing (CFIA)* study (Birkett et al., 1999). This globally conducted study clearly pointed out the need for internal auditors to possess a radically expanded set of skills

and competencies to cope with massive change and complexity in both private and public sector operations. A Delphi study, conducted as part of the comprehensive *CFIA* study, concluded that in the context of burgeoning change and uncertainty, the internal audit function adds value by providing assurances to those charged with organizational governance that organizational risk exposures are well understood, being monitored, and under control. A further conclusion of the Delphi study was that internal audit activities in the future would most likely be conducted through flexible, and many times self-directed, work teams featuring varying mixes of internal auditing specialists, application specialists, and general organizational personnel.

Another seminal IIA Research Foundation study by Rittenberg & Covalleski (1997) described and assessed the impact of the “outsourcing phenomenon” and made the following summary points for the rapidly evolving internal auditing profession: (1) There is a monumental change underway in the way in which auditing is being done; (2) Internal auditing work can be done by non-employees; (3) Audit independence is a problem, but outsourcing is not the “make or break” issue; (4) Existing internal auditing departments should act as if they were going to be “market tested”; and (5) The IIA should rethink its process for establishing standards and policies.

In the late 1990s, partly as a result of insightful, IIA-sponsored research studies as well as numerous forward-thinking articles in The IIA’s flagship journal, *Internal Auditor*, The IIA recognized a fundamental need to formally reassess and evaluate the profession’s governing principles, orientation, and knowledge base of competencies and skills. There was a fourfold purpose behind The IIA’s strategic document “A Vision for the Future,” viz., enhance the economic value of internal auditing; ensure consistently high quality internal auditing; strengthen the professional standing of internal auditing; and achieve broad market awareness of internal auditing (GTF Report, 1999). The Guidance Task Force carried out a comprehensive review of the existing professional standards, the code of ethics, and even the definition of internal auditing. They concluded that the old terminology failed to “adequately reflect the evolution of practice [or] effectively promote the internal audit profession in the competitive marketplace” (Krogstad, Ridley & Rittenberg, 1999). The new Professional Practices Framework embraced the following purposes (GTF Report, 1999):

- “1. Provide a flexible framework for supporting and promoting a broad range of value-adding internal auditing activities.
2. Delineate basic principles that represent the practice of internal auditing as it should be throughout the world.
3. Foster improved organizational processes and operations.
4. Require a quality assurance mechanism to ensure compliance with the *Standards*.

5. Achieve “preferred provider” recognition in the marketplace based on worldwide reputation for high quality internal auditing services.”

The new definition of internal auditing is designed to accommodate the profession’s expanding role and responsibilities:

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

Chapman & Anderson (2002) explain that this new definition of internal auditing presents a new image of the profession in six significant ways:

1. As **an objective activity**, not necessarily established within the organization, the revised definition permits internal auditing services to be provided by “outsiders,” in effect acknowledging that quality internal audit services can now be obtained through outsourcing.
2. By emphasizing that the scope of internal auditing encompasses **assurance and consulting** activities, the new definition projects internal auditing as proactive and customer-focused, and concerned with key issues in control, risk management, and governance.
3. By explicitly stating that internal auditing is **designed to add value and improve an organization’s operations**, the new definition underscores the significant contribution that internal auditing makes for any organization.
4. By **considering the whole organization**, the new definition perceives internal auditing’s mandate much more broadly, charging it with helping the organization accomplish overall objectives.
5. The new definition assumes that controls only exist to help the organization manage its risk and promote effective governance. Such a perspective considerably **broadens the horizons** of internal auditing and expands its working domain to include risk management, control, and governance processes.
6. The new definition accepts that the internal auditing profession’s legacy, consisting of its **unique franchise** in being a standards-based profession, may well be its most

enduring and valuable asset. Rigorous standards provide the basis for crafting a documented, disciplined, and systematic process that assures quality performance on internal audit engagements.

The new definition of internal auditing is enshrined in a comprehensive *Professional Practices Framework* (IIA, 2002a), a structural blueprint of how the body of knowledge in internal auditing and the applicable guidance fits together. The *Professional Practices Framework* consists of three categories of guidance: *Standards and Ethics*<sup>9</sup> (mandatory guidance), *Practice Advisories* (strongly recommended), and *Development & Practice Aids* (helpful reference materials developed or endorsed by The IIA). The Framework organizes the full range of guidance in a manner that is readily accessible and timely for internal audit practitioners. It is expected to be responsive to the needs of internal audit practitioners and grow more robust in the coming years. The IIA *Standards* and elements of the *Professional Practices Framework* are available on the IIA's Web site at <[www.theiia.org](http://www.theiia.org)>

It is evident from the preceding historical review and summary that internal auditing has evolved remarkably over the last 60 years and has gained an increasingly important role within organizations, whether in industry, government, or the nonprofit sector. Alongside this development, the internal auditing function today accepts a broader responsibility toward the organization itself and its stakeholders. By offering expanded assurance and consulting services to the organization, i.e., in particular to the audit committee of the board of directors as well as to executive management, the internal audit function effectively contributes to improved organizational governance. Furthermore, information assured by internal auditors enhances both internal and external decision-making, thereby improving the deployment, and the effective and efficient use of scarce organizational and economic resources.

Based on an understanding of how contemporary organizations function and the relevant influences, the internal audit function and its activities will be discussed using myriad perspectives in the following chapters of the *Research Opportunities in Internal Auditing* monograph. These perspectives will provide a richer and fuller understanding of the context of the internal auditing function and its activities in modern organizations and thus help generate the types of basic and applied research questions that are likely to be of serious and enduring interest to academics and practitioners.

#### **IV. Prospects for the Internal Auditing Profession**

Contemporary organizations are increasingly information-dependent and knowledge-intensive, and engage in extremely specialized and sophisticated operations across industries and sectors globally. The development of new organizational forms in the information age,

with the forging of strategic alliances and the emergence of virtual organizations, has dramatically altered the purpose and functioning of organizations as well as the attendant needs for exercising control.<sup>10</sup> The controls landscape within organizations today is quite different from those existing in the industrial-era traditional organizations for most of the 20<sup>th</sup> century. In this radically changed business environment, the internal audit function has become a major support function for management, the audit committee, the board of directors, the external auditors, as well as key stakeholders. Properly conceived and implemented, the internal audit function can play a critical role in promoting and supporting effective organizational governance.

As multinational enterprises have recognized an increasing array of risks facing the organization, it is no surprise that the demand for risk management professionals has risen dramatically (cf. Bernstein, 1996). Any disciplined approach to growth and value creation assumes that the organization is managing all manner of significant and likely risks effectively. Risk can be considered both at the macro or portfolio level (enterprise-wide risk management) as well as the micro or departmental level. Risk management is frequently an area in which internal audit can contribute greatly by furnishing analyses and providing wise counsel to top management and the board of directors. The internal audit function also performs micro-level risk assessment for its own purposes to identify those areas which demand the greatest efforts on the part of the internal audit function and for achieving appropriate audit coverage of the audit universe over defined periods of time (Ramamoorti & Traver, 1998). Internal auditors can play a significant “partnering” role with management in establishing and monitoring business processes for the assessment, measurement, and reporting of risks in general and in implementing enterprise risk management initiatives. Modern approaches to risk-based internal auditing allow for the assessment of risks and linking them to business objectives systematically (McNamee & Selim, 1998; Walker, Shenkir, & Barton, 2002; DeLoach, 2000). Indeed, the internal audit function can facilitate the processes by which business units “can develop high quality risk assessments,” and this can in turn be very useful to the internal audit function in planning its own work, primarily by enhancing the quality of decision-relevant information and minimizing duplication of effort (Walker et al., 2002).

One of the key premises today in any organization is that the presence of a strong internal audit function can go a long way in supporting and promoting effective organizational governance. Much of organizational governance has to do with effective monitoring and oversight of risk management, and internal auditors, if perceived as “risk management experts,” can expect to play an immensely significant and high-profile role within organizations in the coming decades. With the recent New York Stock Exchange requirement for listed companies to have an internal audit function, the profile of the internal audit function has



been raised considerably. By being given a seat at the table where high-level discussions of organizational governance occur, the horizons for the profession have been considerably expanded and its opportunities to add value have grown exponentially. However, the challenge remains for internal audit professionals to develop a keen understanding of the value proposition they offer and manage their perception and image both within and without organizations. Once the internal audit function gains the trust and confidence of those charged with governance, it can proceed to deliver outstanding performance and value using the combined wealth of knowledge and experience possessed by its personnel in control best practices, risk monitoring and management, and governance structures and processes. Specifically, with all of the Big Four professional services firms demonstrating a strong interest in developing their internal audit co-sourcing practices, the internal audit profession is poised for significant international impact. Such globalization of internal auditing activities and the attendant recognition of the value added by the internal audit function are indeed welcome trends.

In conclusion, the 21<sup>st</sup> century presents much promise and unprecedented growth opportunities for the internal auditing profession. However, developments in practice must be carefully studied by interested academics so that a body of knowledge is systematically built up and transmitted to future generations of internal auditing professionals. The extant body of knowledge should not only be critiqued and constantly refined to reflect the current state of the art, but should also encourage and stimulate, through research, leading edge thinking that so often produces innovations in practice. We believe that this report constitutes an excellent source to start the journey that will yield important insights into internal auditing research, practice, and education.

## **V. Summary of Research Issues**

The historical overview of internal auditing and the contemporary expectations from, and roles and responsibilities of, the internal audit function within organizations suggests a variety of research questions for exploration and investigation.

Appearing in the Appendix is a series of potential research questions organized under captions such as: historical/archival/policy-oriented research, contemporary practice: state of the art of internal auditing, theory/common body of knowledge/education, prospects, and miscellaneous. We hope that interested academics would benefit from careful study of the suggested research questions and the lines of inquiry that they open up for future research investigation. (Note: The list of research questions in the Appendix is intended to be merely illustrative and is by no means exhaustive).



## **VI. Appendix I: Chapter Research Questions**

### **Historical/Archival/Policy-Oriented Research**

- How can we develop a simultaneous and integrated understanding of the global historical development of the internal audit profession? (i.e., this might require a comparative Geographic Time Tables of History approach)
- How has the evolution and development of internal auditing differed across regions of the world? What has been the most common triggering event? (e.g., massive fraud and business scandals followed by legislation supporting internal auditing)
- Would comparative historical research, for instance, on the public policy implications of prohibiting the joint supply of external and internal auditing by the same public accounting firm yield useful lessons?
- Why does the status of the internal audit function frequently seem to be a direct consequence of organizational leadership (C-suite executives) attitudes toward and expectations from internal audit? Would historical case studies of the long-standing internal audit functions in companies like J.C. Penney and Ford Motor Company shed light on this?
- Historically, why have developments in internal auditing typically lagged developments in external auditing? (e.g., because internal auditing has not been yoked with organizational governance in the past? Not seen directly to contribute to the public interest? Not mandated or legislated?) In this era of investor capitalism, is this going to change with the suddenly heightened profile of the internal auditing profession? Does the chief audit executive, in his or her new role, need directors & officers (D & O) liability insurance coverage?
- How can we assess the impact of economic vs. cultural variables on the evolution of the internal auditing profession?
- To what extent are internal auditor attitudes and posturing reminiscent of “patterns of behavior” (cultural process variations) versus “patterns for behavior” (variations in cultural ends or ideals) in organizations?

### **Contemporary Practice: Internal Auditing, State of the Art**

- What are some common features of internal audit methodologies, approaches, and tools used by world-class organizations? Can we distill best practices from such “in search of excellence” studies?
- What impact is industry specialization having on internal audit professionals and on the internal audit function? What about the impact of technology and globalization?
- Why have internal auditors become so “opportunistic” in taking on a series of special projects on a contingency basis?
- How valuable is it to perform *ex ante* as well as *ex post* “event studies” of the promulgation of IIA standards? Have the *Standards* been effective in influencing practice? Do they serve as measures of the quality of performance of internal audit engagements?
- How good is the alignment between organizational goals and the internal audit function’s objectives, especially when internal auditors also assume the role of change agents?

### **Theory/Common Body of Knowledge/Education**

- What are the fundamental postulates of internal auditing? What are the epistemological foundations of internal auditing, including relevant concepts and constructs, i.e., ways of knowing, quality and quantity of evidence, risk metrics, problems of fact and problems of value, justification, independence and objectivity, process and methodology, etc.? How and in what respects has internal auditing diverged from external auditing over the years? What is the “Philosophy of Internal Auditing”? (cf. Mautz & Sharaf, 1961, a theoretical approach)
- Do we need a follow up to the *Competency Framework for Internal Auditing (CFIA)* study every five years or so? Should we regard internal auditing as an expanding profession and take appropriate steps to examine its structure, scope, and content on a global basis and with sufficient frequency to keep the common body of knowledge current and relevant?

- How should internal auditing, a pragmatic field like surgery, be taught at the university level? How do we instill a “lifelong learning” orientation in those who wish to become internal auditing practitioners?
- What does the exercise of professional judgment mean in the context of internal auditing? How do we design mechanisms that effectively capture the experience and expertise of seasoned internal audit professionals and help with expert-novice knowledge transfer?

### **Prospects**

- How could we try to chart the future of internal auditing? To what extent would studying disparate trends in organizational governance, technology, globalization, business complexity, demographic trends, education, etc. help?
- What might we find from a systematic Porter-type “Five Forces Analysis” for internal auditing to trace the development, current state, and future preparedness of the internal auditing profession?

### **Miscellaneous**

- How useful is it to look at internal auditing theory using a “systems perspective”? Can organizational studies that adopt a holistic, integrated view and consider internal auditing in the context of the entire organization provide useful insights?
- Does the fact that the CIA is a global designation instill pride and *esprit de corps* in members? Does the fact that they belong to a global profession motivate members to hold themselves out accordingly and exhibit greater professionalism?

## Footnotes

<sup>1</sup>The inaugural New York City meeting location was no doubt because of the city's flourishing commercial activity and significance, but also because two of the earliest doctoral dissertations on the then fledgling subject of internal auditing were written by distinguished academics, both trained at Columbia University, New York City. These two pioneers of internal auditing — Dr. C. Aubrey Smith, later affiliated with the University of Texas at Austin, and Dr. Victor Z. Brink, later affiliated with Ford Motor Company and Columbia University — went on to write influential books on the subject, *Internal Audit Control* (Smith, 1933) and *Internal Auditing* (Brink, 1941).

<sup>2</sup>Interestingly, “Internal Auditing: A Profession for the 21<sup>st</sup> Century” was the 1996-97 theme chosen by then IIA Chairman of the Board Anthony J. Ridley to describe his vision for the profession during his year at the helm.

<sup>3</sup>In the United States, by the mid-19<sup>th</sup> century, internal auditors were actively assisting external auditors in investigating internal frauds at railroad companies in New York and New Haven (Previts & Merino, 1998).

<sup>4</sup>However, this transition has frequently not occurred in many organizations; the primary stumbling block is best captured by the phrase: “the issue of serving two masters.” On the one hand, internal auditors are typically employed by the organization (management) and need the support and cooperation of executive management to perform their duties effectively; on the other hand, when internal auditors are asked by the organization's audit committee of the board of directors to critique management performance, they must answer fearlessly recognizing their ultimate allegiance to those charged with organizational governance, not management. This unhappy situation of reporting to two masters creates much friction and tension for internal auditors. Indeed, if delicate issues are not managed tactfully, the ensuing breakdown in communications and cooperation can lead to a compromise of the internal audit function's independence and objectivity and/or a diminished organizational status for the internal audit function.

<sup>5</sup>In 1964, Bradford Cadmus published his seminal *Operational Auditing Handbook*. Earlier in 1947, he had been appointed The IIA's first paid managing director (Flesher, 1996).

<sup>6</sup>Lawrence Sawyer is also well-known for having written the celebrated book, *The Practice of Modern Internal Auditing*, now carrying the eponymous title, *Sawyer's Internal Auditing* (Sawyer & Dittenhofer, 1996, 4<sup>th</sup> Ed.). Larry Sawyer passed away in September 2002, just as this chapter was being finalized.

<sup>7</sup>MIIA = Member of the Institute of Internal Auditors, is a professional designation still used in the UK.

<sup>8</sup>The NYSE requirement for all publicly listed companies to have an internal audit function is a watershed event in the continued evolution of internal auditing in the United States. Such a mandate reinforces the credibility and legitimacy of the internal audit function for large, well-managed companies.

<sup>9</sup>Mandatory guidance consists of core materials: the Code of Ethics and *Standards for the Professional Practice of Internal Auditing (Standards)*. The purpose of The Institute's Code of Ethics is to promote an ethical culture in the profession of internal auditing. The *Standards* are the criteria by which the operations of an internal audit department or function are evaluated or measured. They are intended to represent the practice of internal auditing as it should be. Three sets of *Standards* have been issued: Attribute, Performance, and Implementation Standards. The Attribute Standards address the attributes of the organizations and individuals performing internal audit services. The Performance Standards describe the nature of internal audit services and provide quality criteria against which the performance of these services can be measured. The Attribute and Performance Standards apply to all internal audit services. The Implementation Standards expand upon the Attribute and Performance Standards, providing guidance applicable in specific types of engagements. These standards ultimately may deal with industry-specific, regional, or specialty types of audit services (IIA, 2002a, 2002b).

<sup>10</sup>One indicator of the sophistication and complexity of internal audit activities is the number of specialty certifications sponsored by The IIA, beyond the generic Certified Internal Auditor (CIA) designation: Certificate in Control Self-Assessment (CCSA), Certified Government Auditing Professional (CGAP), and more recently, Certified Financial Services Auditor (CFSA).

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