

THE FUTURE PERSPECTIVES OF THE INTERNAL AUDIT FUNCTION

*Cristina Boța-Avram*¹

*Atanasiu Pop*²

*Florin Boța-Avram*³

ABSTRACT: The aim of the paper is to provide an overview over the challenges and opportunities that internal auditors are going to face with, in the context of current economic and financial worldwide crisis. Using fundamental type of research, but also combining inductive with deductive type of research, we have identified several key trends that will certainly influence next perspectives of internal audit function in the coming period. Our findings show us that next future will give some important challenges for the internal auditors, consisting in developing skills in assessment the effectiveness of risk management which will help to increase the added value provided by the internal audit, and most importantly, will increase internal audit's accountability. Even more the international professional bodies that coordinate internal audit activity will have to make all necessary efforts for the development of practical guidelines for assessing the effectiveness of risk management so internal auditors to be equipped with the necessary skills to face with the higher and higher expectations that will characterize the future perspectives of the internal auditing.

Keywords: internal audit function, risk management, internal auditor, added value, internal audit standards

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Introduction

The impact of current economic crisis over the global economy is truly devastating, this fact being accepted unanimously by the whole crowd of professionals from various areas of the world economy. In order to combat the negative effects of this crisis, but also to help deterrence and prevention in the next future of negative phenomena such magnitude, it becomes absolutely essential to pay attention to identify the potential factors that had a major contribution in the generating of this economic crisis. If we analyze the various reports of legislative and professional level bodies, but also the articles from international financial press, we noticed there are several factors that had been caused the global economic crisis on which the vast majority of experts agreed, such as deficiencies in risk management systems, compensation systems for corporate management without economic substance, deficiencies of ratings established by rating agencies with good international recognition, deficiencies in the rules of banking and government policies that encouraged banks to give excessively loans to the population, without being sure about the certainty of repayment ability, the inefficiencies in the application of accounting concepts such as the use of fair value accounting or inefficiencies of the external auditors' work. Trying to analyze the whole range of causes of global economic crisis, our main objectives are the identifying of the next perspectives of this difficult economic context over the development of internal audit function. Few specialists in literature and most recently have focused attention on accountability of internal audit in the current economic crisis. It becomes clear that next future will give some important challenges for the internal auditors, consisting in developing skills in assessment the effectiveness

¹ Faculty of Economic Sciences and Business Administration, St. Teodor Mihali, No. 58-60, 400591, Cluj-Napoca, Romania, Email: botaavram@gmail.com

² Faculty of Economic Sciences and Business Administration, St. Teodor Mihali, No. 58-60, 400591, Cluj-Napoca, Romania, Email: atanasiu.pop@econ.ubbcluj.ro

³ Faculty of Economic Sciences and Business Administration, St. Teodor Mihali, No. 58-60, 400591, Cluj-Napoca, Romania, Email: botaavramflorin@gmail.com

of risk management which will help to increase the added value provided by the internal audit, and most importantly, will increase internal audit's credibility.

Literature review (Times New Roman 12, bold)

Early 21st century was a tumultuous one in terms of economic and financial life of the world, being quaked by the multiple financial scandals arising from bankruptcies of large corporations that have occurred since 2001 (Enron), and continuing to 2002 (WorldCom, Qwest Communications, Adelphia, Global Crossing, Nortel, Parmalat), they make an imprint not only on the work of external audit, but for internal audit activity also. International specialty literature showed that there were some specialists interested and focused on the analyzing the impact and changes on these financial scandals over the internal audit's development. Carcello, Hermanson and Raghunandan (2005) studied the changes in internal auditing during the time of the Enron and WorldCom financial disasters and the related legislative and media focus on internal control and corporate governance. Using data gathered from 271 mid-sized US public companies they found that internal audit budgets, staffing levels, meetings with the audit committee, and meeting length increased markedly during this time. Their findings indicated that internal audit budgets and staffing levels increased by over 10 percent on average from 2001 to 2002. Internal audit meetings with the audit committee increased in frequency and length by over 25 percent on average. Also, if from 2001 to 2002 57 (34) percent of companies increased the internal audit budget (staffing level), this study (Carcello *et. al*) showed that very few companies decreased their internal audit budgets or staffing levels (less than 13 percent each). Another finding of this study is that, while 37 (40) percent of audit committees increased the number of meetings (average meeting time) with internal audit, decreases were observed in less than four percent of companies.

A significant analysis of these big corporate failures that had been shuddered the financial life at the beginning of 21 century was made by Gordon Smith, the president of Canaudit Inc., a company that had provided training and technical audit consulting services to the internal audit community for over 16 years. Smith (2005) argues for the necessity of strengthening the internal audit's position in the corporate using of human resources with specific skills training, promoting the idea of reconstruction of internal audit departments with staff who possess technical skills in identifying specific risk business. Smith (2005) considers that one of the most significant causes of such big corporate failures was the outsourcing of the internal audit activity, because "*outsourced auditors often do not achieve the same understanding of the business and the people performing the everyday business transactions like internal auditors do*".

Another consequence of these scandals was the increasing of the expectations placed on audit committees. The multiple changes of audit committees after Enron and Andersen failures were in the attention of many international specialists (like Glater and Treaster, 2002; Hennessey and Whitman, 2002; Lublin, 2002). More and more it was underlined the necessity for frequent audit committee meeting that should include more detailed discussions with both internal and external auditors (Herdman, 2002). An element more and more obviously is that audit committee is focusing on increasing the cooperation with internal audit department and the number and length of the meeting would be longer.

Trying to design a model of internal audit in the near future, PricewaterhouseCoopers conducted a survey in 2007, before the spread of financial crisis events that have been subsequently affected the entire global economy. The purpose of this study was to identify the main trends that internal audit will have in its next evolution. The main conclusions of this report show that:

- internal audit departments should adopt an internal audit's approach in the light of reasoning centered on professional risk if the internal auditors want to remain the key elements in risk management and provide management advice;
- the study indicates that there are five identifiable trends - globalization, changes in risk management, technological, organizational skills and talent, and changing role of internal audit -

all these will have a strong impact on internal audit function in the coming years. It is essential to understanding these trends and their implications, so that internal audit to be able to provide necessary help to the general management regarding the process of risk management, so that in the end internal audit function to provide added value to the organization;

- in addition, the results of this study have indicated that the potential added value of the internal audit function is dependent on two factors: the primary nature of the internal audit activity and the relative maturity of the processes of risk management within the organization.

The period before current global economic crisis was characterized by increasing of internal audit's role in the process of risk management. Risk management is a process characterized by complexity, which starts with the implementation of an infrastructure well designed, continuing with the identification, analysis and risk assessment, the establishment of certain measures designed to combat or diminish any potential loss as a result of such risks. Risk management contributes, in this way, to the identification and the assessment of the activities that could determine the reduction of frequency of negative events, leading to achieve a certain safety level above the pre-application programs for risk management.

Starting from the premise of an active involvement of internal audit function in the process of risk management within companies, we can say that these risks should be maintained at reasonable levels, which could afford to internal audit to be helpful at the earlier identification of negative risks that could determine negative phenomena like the one starting with the summer of 2007.

Research methodology

The methodology of research used in this paper is based on a combination of the inductive with deductive research that is designed to help us in the obtaining of verifiable knowledge with a strong contribution at the development of the scientific knowledge in this area. In order to touch our research objectives we will proceed at a harshly documentation over the most recent publications: articles in journals, governmental acts, reports, standards, recommendations issued by international professional organisms that coordinate internal audit activity. We focused on the analysis of the opinions and information identified by using descriptive and technical documentation with the combination of participating and non-participating observation method. Our final goal was to identify the main coordinates that will characterize the next evolution and development for internal audit function.

The context of current economic crisis

The first signs of this global economic crisis were felt in the summer of 2007, when financial institutions began to recognize that they were facing with growing losses related significant subprime mortgages (known as having a high rate of risk). The result was the investors were trying to escape the financial derivatives based on subprime mortgage system, redirecting investment to speculation based on the price of basic goods. At the same time, the system real estate in the United States is faced with the situation becoming more critical, embodied in dramatic decreases in the price of the property transactions were made. Gradually, the volume of liquidity available on the global credit market has experienced sudden and significant decrease, which further led to a decrease in confidence in the financial system, increasing the cost of credit, the availability of increasingly reduced resources in credit markets, materialized into the so well known already "credit crunch" (credit crunch), which later turned into a global economic crisis affecting the national economy cascade with different degrees of economic development.

A recent report published by ACCA on the financial crisis, has identified two major categories of factors that gave rise to the onset of the credit crunch in the U.S., namely:

1. Main factors:

- The failure of corporate governance (to be acting in the interests of shareholders, if not a conflict of interest arises which requires professionalism and ethics at the company level);

- Failure institutions to properly assess and manage inherent risks between the business and pay system and granting incentives, which were not designed for the benefit of all shareholders;
- Errors in identifying and managing risk;
- Influence of low or even a minimum output of risk management departments of the banks;
- Weaknesses in financial reporting and regulatory systems.

2. *Secondary factors:*

- Too great complexity of financial products, with little experience of managers across the risks associated with these products;
- Human errors embodied in failures in assessing cultural influences and motivational factors such as rigidity in thinking and unwillingness to adapt to change;
- Lack of proper understanding by the management in designing business models, leading to poor management oversight;
- The lack of strict supervision of the non-executive directors, one possible cause being the poor understanding of the complexity of businesses;
- Unhealthy habits acquired as a result of a market that was too long in a position enabling environment for running hedge transactions.

The major impact of the crisis on the global economy has led many committees and bodies to investigate which were the main causes which led the outbreak and spread of this global economic crisis. A group of legislators (Senior Supervisors Group, 2008) from United States, Britain, France, Germany, and Switzerland have issued a report highlighting gaps and shortcomings in risk management processes, promoting the idea that risk management was a key contributor deficient in generating this current economic crisis. Analyzing several companies in the area that are more and more affected by the consequences of the crisis (especially companies providing financial services), the report aims to highlight which were the elements that characterized companies less affected by economic crisis and characteristics of companies more affected by the recession economic crisis. A negative element identified in the area of the affected companies was the failure of risk management in the identifying and managing risk effectively due to the increasing complexity of services offered and the risky nature of business conducted. One of the conclusions of this report is that affected companies will have to review procedures regarding the functioning of the risk management process so that efficiency is significantly improved.

Analyzing potential causes of the global economic crisis, from internal audit's point of view, we consider the generation of these negative phenomena was occurred by at least following situations:

1. Internal audit department was not interested in respecting and ensuring compliance with internal audit standards, this disregard being manifested by the internal audit customers (management and audit committee).
2. Internal Audit Department carried out its assessment regarding the risk management process and the final reports over the potential risks that could threaten the normal course of business were submitted to the management of the companies, but internal auditors were not sufficiently able to identify and report deficiencies within a reasonable time for the operation of significant changes in the process of risk management.
3. Internal Audit Department has made assessments of risk management, but these results were not communicated to the management.
4. Internal Audit Department fully respects the international standards for internal audit by doing the assessment, monitoring and reporting to management the results on the effectiveness of risk management, but management and the audit committee had ignored all these reports, considering them too less important.

Leech T., a distinguished member of the Canadian Institute of Internal Auditors and Inspectors Association of Certified Fraud Examiners in the U.S. and internationally recognized

because of his knowledge in management risk, risk assessment, development of internal audit and prevention and detection of fraud events, had been conducted a lot of many surveys in many organizations in several countries from different sectors of activity. The results of these studies (Leech, 2009) determined Leech to appreciate that one of the most frequently encountered situations (which could actually be considered one of the causes of the crisis) was the situation when *the internal auditors have achieved the requirements for assessing and reporting on risk management, but they were unsuccessful in identifying and reporting within a reasonable time the deficiencies that had been threaten the efficiency of risk management.*

The new version of the internal audit standards adopted by the Institute of Internal Auditors (IIA), revised in October 2008 and applicable from January 1 2009, present certain substantive changes, which are designed to enhance the role and contribution of internal audit in monitoring, assessing and reporting on the effectiveness of conducting of risk management process. In this context, it becomes absolutely necessary to establish a reference framework in assessing and reporting on the effectiveness of risk management, the main objective of this framework being the transmission of the necessary skills for internal auditors to ensure compliance with IIA standards, particularly in the context of an environment so threaten by the global economic crisis phenomena that generated such unimaginable negative consequences.

Economic crisis: key themes for refocusing internal audit activity

It becomes more than obviously this current economic crisis, which is characterized by some experts as unprecedented, will have a significant impact on the development of several areas, one of these being the internal audit activity. Proposing to determine the coordinates that will determine the future evolution of internal audit, Ernst & Young conducted a study in 2008 among internal audit directors from 348 companies in 35 countries. The results obtained were interesting:

- The scope of internal audit will expand significantly in the forthcoming period and the role of internal audit in its efforts of improving the activities and the processes within the companies will become more and more focused on strategic aspects;
- Significant changes will have to be made in some of the following categories: governance, human resources involved, the infrastructure activities performed;
- Internal audit will have to focus over the development of internal audit skills' necessary in the process of risk management that have to be focused more and more over the operational and strategic risks. In the same time, internal audit will have to develop better skills to identify a wider range of risks specific to different business sectors;
- The expectations of management and audit committees vis-à-vis internal auditors will increase significantly, given to the fact that importance of internal audit and its ability to combat the negative effects in the context of current economic crisis is becoming more and more.

In order to evaluate the extent to which the global economic and financial crisis has impacted internal audit activities, IIA and IIA Research Foundation (IIARF) conducted a survey in early March 2009, asking the participants about the overall impact of the economic slowdown on their organizations and, subsequently, over their internal audit efforts. The respondents were asked a lot of questions in order to determine the impact of the current economic crisis on their internal audit activity. So, one first question asked respondents was to identify if their budgets have changed during the past 12 months. Although 41 percent of respondents stated their budgets have stayed about the same (as shown in Figure no.1), 51 percent stated their budgets have decreased anywhere from less than 10 percent to more than 50 percent.

Figure no.1

The impact of Current Financial Crisis on Internal Audit Budgets

Response	Chart	Frequency	Count
Increased		9.1%	33
Stayed about the same		41.2%	149
Decreased by 10% or less		26.5%	96
Decreased from 11 to 25%		15.5%	56
Decreased from 26 to 50%		7.2%	26
Decreased more than 50%		0.6%	2

It is obviously that current economic crisis continues to affect organizations at different levels. In this context many internal audit activities are going to change the focus of their activities, transforming a significant part of more traditional audit work and concentrating more on the emerging risks that have surfaced from the changing business and economic environment. In order to determine the extent of these future changes, the participants at IIA survey were asked to specify how internal audit coverage has evolved during the past year and identify the areas where audit coverage will increase during the next 12 months in 12 categories ranging from financial and operational risks to liquidity and reputational risks. In nine out of the 12 categories (as it can be seen in Figure no.2), the most of the respondents indicated that their work has remained the same in the past 12 months. However, many internal audit activities have changed the amount of coverage in areas closely linked to the current economic crisis. The two areas where the majority of respondents indicated that coverage has increased during the past year are cost/expense reduction or containment (47 percent) and operational risks (47 percent).

Figure no.2

Changes in Internal Audit Activities during the Past 12 Months

		Increased	Decreased	Remained the Same	Not Applicable
Financial risks (general)	Count	146	8	199	6
	% by Row	40.7%	2.2%	55.4%	1.7%
Sarbanes-Oxley testing or other support	Count	38	71	159	91
	% by Row	10.6%	19.8%	44.3%	25.3%
Operational risks	Count	170	20	167	5
	% by Row	47.0%	5.5%	46.1%	1.4%
Compliance risks	Count	120	15	220	8
	% by Row	33.1%	4.1%	60.6%	2.2%
Credit risks	Count	120	4	172	67
	% by Row	33.1%	1.1%	47.4%	18.5%
Liquidity risks	Count	96	6	182	78
	% by Row	26.5%	1.7%	50.3%	21.5%
Effectiveness of risk management	Count	125	5	196	34
	% by Row	34.7%	1.4%	54.4%	9.4%
Company exposure to third parties in financial distress	Count	142	2	161	57
	% by Row	39.2%	0.6%	44.5%	15.7%
Cost/expense reduction or containment	Count	171	2	165	23
	% by Row	47.4%	0.6%	45.7%	6.4%
Model/valuation validation	Count	54	7	163	137

Source: IIA (2009)

When asking about the areas that internal audit will focus its attention over the next 12 months, more than half of all respondents (56 percent) will increase their focus over financial and operational risks, and nearly 50 percent of all will increase their focus in areas like cost/expense reduction or containment areas and in assessing the effectiveness of risk management efforts (47 percent).

Figure no.3

Changes in Internal Audit Activities for the Next 12 Months in the vision of respondents

Response	Chart	Frequency
Financial risks (general)		56.3%
Sarbanes-Oxley testing or other support		11.5%
Operational risks		56.3%
Compliance risks		38.5%
Credit risks		42.6%
Liquidity risks		31.3%
Effectiveness of risk management		47.3%
Company exposure to third parties in financial distress		37.9%
Cost/expense reduction or containment		49.5%
Model/valuation validation		12.4%
Off-shoring/vendor risks		16.8%
Reputational risks		19.0%

Another significant conclusion of IIA survey is given by the necessity of internal audit activity of assessing the stakeholders' expectations. For that they have to ensure their efforts will remain aligned to those of their stakeholders. In this direction internal audit should make more efforts for providing assurance to the board, audit committee, management and regulators (IIA, 2009):

- **Boards and audit committees.** Internal audit must offer an assurance over the effectiveness of risk management efforts and on the adequacy of financial and operational controls. Internal auditors have to become the “eyes and ears” of the board and audit committee, providing independent and objective feedback on areas of interest, as well as underlying companywide potential risks and performance-enhancing opportunities.
- **Management.** Internal audit must assure the management on the effectiveness of operational and financial controls, as well as provide insight on cost structure and reduction opportunities.
- **Regulators.** Internal audit have to assure regulators over the efforts of the organization in the assuring of compliance and transparency.

Another study was realized by IIA Global Audit Information Network (IIA GAIN, 2009) consisted into a roundtable survey from 34 Fortune 100 company chief executive auditors. The results of the roundtable discussions show that internal audit will have to extend its attention in several key areas, from which the assessing of the effectiveness of risk management will play an

increasingly vital role for internal auditing. Also internal audit will play a significant role in the process of connecting the organization's business strategies with identified risks. Now it is the moment for internal auditors to enhance the stature and credibility of their internal audit activities.

The roundtable participants also offer a lot of significant suggestions that internal auditor must take into consideration in order to face to the new challenges that internal auditors have to face with:

- Enhancing the communication with management and the audit committee in order to know better their expectations.
- Increasing of the focus over risk management and governance processes and for that it is necessary a hard looking at the organizational structure and business strategies.
- Strengthen the risk assessment process.
- Operating with a more flexible and adaptable audit plan which has to be aligned with business objectives.
- Focusing on recession-related risks and activities, especially by incorporating the cost structure and revenue enhancement review into the audit activity.
- Expanding the fraud testing in the audit plan through incorporating technology in order to review a broader transaction for the potential anomalies.
- Strengthening the relationships and communications with the organization's other governance, risk, and control functions and meeting with risk champions regularly.
- Enhancing the efficiency of the audit processes.

Analyzing the results of the studies presented above, it becomes clear that internal audit will need to redefine the centers of interest, the adapted the scope of traditional objectives to those generated by the new economic context of the crisis. In this context, the professional organism from international level will play an important role in coordinating the internal audit activity, which have to be more and more directed to the defining of a reference framework very well established within the involvement and responsibility of internal audit in evaluating and reporting on audit effectiveness of risk management to be achieved.

Conclusions

In these days of this global economic crisis, it becomes clear that the importance of internal audit in companies will be increasingly higher. Developing the skills of identifying key risks, particularly those arising from global economic downturn, internal audit is seen as a key element in the fight for the combating of the negative effects of the current economic crisis but also to prevent other such negative phenomena. Internal audit has now the chance to change its role in the process of risk management into a more strategic outcome which would not only prevent future catastrophes of this kind, but also will make the company to operate more efficiently.

The increasing responsibility of internal audit in the prevention of different crisis events is very well highlighted by President of IIA, Richard Chamberlains, which argues that many internal audit departments have failed to provide a reasonable level of assurance on the effectiveness of risk management. Potential causes may be either internal audit did not give the adequate importance to risk management either the internal auditors were not allowed to put the right questions or were ignored or recommendations made by them in order to improve the risk management strategy were totally ignored by the management of the company. On the other hand, even if the internal audit would be conducted with maximum efficiency evaluation of the effectiveness of risk management, it would not be able to prevent the crisis without the support of the overall management and the audit committee of the company. In this context the importance of effective communication channels between management, audit committee and internal audit becomes more than obviously, and must operate in a coherent whole that truly contribute to preventing possible future economic crisis. The role of IIA as the main international body that coordinates the activity and practices of

internal audit all over the world becomes now even greater, the biggest pressure over this body being generated by at least two factors:

- The need for recognition of internal audit's responsibility in combating the negative effects of the crisis, and thus strengthening the image of the internal audit;
- The need for immediate fitting internal auditors with the necessary skills and information for the ensuring of the highest degree of compliance of the provisions of internal auditing standards, which finally should help at the increasing of the likelihood of preventing in the near future of such major economic collapses.

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