Internal Auditing’s Identity Issue: Management-Orientated or Accounting-Related?

Topic:
Modern Internal Auditing: Accounting-Related or Management-Orientated?

- Describe the development of internal auditing from accounting assurance only to value adding for management
- Explain how internal audit has become a key advisor to management on aspects beyond finance and accounting
- Discuss the changing role of internal audit to consulting
- Address the balance and ability to perform both assurance and consulting on nonfinancial aspects

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Executive Summary

The practice of internal auditing has accounting assurance roots, yet as time moves forward, modern internal auditing seems to act more management-orientated than accounting-related. Thus, the interesting question of whether internal auditing is more orientated towards management or accounting comes up. Additionally, many may question how the practice came to be what it is today. The evolution of modern internal auditing is seen through the changes made to the Statement of Responsibilities, position papers that The IIA has released, the International Standards for the Professional Practice of Internal Auditing, and legislation.

An analysis of the history and development of internal auditing is necessary to answer these questions. It is quite clear where internal auditing has gone and where it will go – it is certain that internal auditing has reached beyond its accounting assurance origins to provide assurance to management on nonfinancial business processes. Internal auditing has also moved into consulting on those business processes that it also had assured and is able to balance its assurance and consulting responsibilities. In the future, internal auditing will become the primary profession for management and accounting majors to pursue. This is because this practice allows for these professionals to apply their knowledge in assurance and consulting roles.
Introduction

The practice of internal auditing has changed from an accounting specialty to a much broader, management-orientated practice. However, the idea that internal audit’s identity is only categorized under accounting or management is a fallacy. Accounting in and of itself is a management-orientated practice – the nicknamed “language of business” helps management make strategic decisions in order to increase stakeholder value in an organization. Accounting helps management determine where in the organization to make an investment to become more valuable. Thus, internal auditing is a management-orientated practice due to its association with accounting. How involved internal auditing has become in strategic management practices has changed over time, as the practice has developed to emphasize analyses on business processes, governance, and risk management – areas that go beyond the traditional focus of accounting.

The intersection of accounting and management is unique, with internal auditing at its focus. Businesses that attempt to properly manage their stock and sales look towards accounting systems to determine profitability and losses, whereas the overall assurance that the stock and sales are being properly handled were the responsibility of internal audit. Gradually, management increased its reliance on internal audit’s provision of reasonable assurance that other business processes in the organization were working effectively and efficiently. This was especially the case in organizations where there was mutual trust between the CAE and the board of directors.

While internal audit has traditionally taken the role of assuring management that risks have been mitigated and controls have been properly integrated into processes, it has recently become more involved in consulting management on new risk management and control processes. This seems to be an appropriate responsibility of internal audit, as its ultimate goal is to provide value to management and improve an organization’s operations, per The IIA’s definition of internal auditing.

An additional aspect of modern internal auditing is its ability to balance both assurance and consulting within its practice. Not only is internal auditing able to provide reasonable assurance regarding major (and potentially regulated) business processes, but an internal audit function or contractor is able to consult management on ways to run the organization more efficiently. How better to provide value than to not only provide assurance on the organization’s operations, but also to provide consulting services to the parts of the organization which require additional assistance to operate effectively and efficiently?

This paper will outline where internal auditing started, how internal auditing evolved into the practice as it is known today, and where internal auditing may be headed in the future.
Internal Audit: Accounting-Related or Management-Orientated?

Internal audit, while its roots may be planted in accounting, is becoming a more management-orientated function and will continue to do so as a result of the trend of the function being more involved in responsibilities beyond that of accounting. That being said, internal auditing will always be a management-orientated practice, and because of its accounting roots, will always be accounting-related. Although accounting is a practice that ensures that the information of an entity is up-to-date and conveys this information to many users, management is the primary beneficiary of the information and uses that information to make informed decisions on how to make the organization more profitable.

The origins of accounting point to the practice primarily being beneficial to managers, who at the spawn of formal business practices, were also the owners of the organization. As organizations increased in complexity and size, owners and managers were no longer necessarily the same people filling multiple roles. Thus, accounting reports began to benefit separate individuals. As organizations grew, a separate function was necessary to ensure that the accounting within a firm was not only up to date, but also accurate. Internal auditing thus began to become a key practice within organizations.

Management is the organization and coordination of the activities of a business in order to achieve defined objectives (“Management” 2019). The definition of internal auditing from The IIA states that 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” (IIA n.d.a).

These roles and responsibilities outlined within the IIA-provided definition indicate that the modern practice of internal auditing is management-orientated and allows internal auditors to involve themselves in nonfinancial oversight projects.

Beyond the definition of internal auditing is the value proposition that internal auditing provides to stakeholders. The IIA specifically identifies governing bodies and senior management as primary stakeholders of an internal audit engagement and specifies that these stakeholders should expect assurance, insight, and objectivity from the practice (IIA n.d.b). Additionally, The IIA specifically states that governing bodies and senior management rely on internal auditing for objective assurance and insight on the effectiveness and efficiency of governance, risk management, and internal control processes.

An IIA position paper on corporate governance states that internal audit provides insight by acting as a catalyst for management and the board of directors of an organization by having a deeper understanding of governance processes and structures (IIA 2018, 1). The IIA believes that internal audit insights can provoke positive change and innovation within an organization and can enable competent and informed decision making (IIA 2018, 2). These are actions of an organization that would be the responsibilities of senior management. The IIA states that as organizations grow, internal audit will expand its role into areas such as culture and behavior and sustainability, areas that are traditionally management-orientated (IIA 2018, 3).
An additional IIA position paper recognizes that while enterprise risk management can be consulted upon by internal auditors, it is ultimately management’s responsibility to manage risks. Thus, the assurance roots of internal auditing are cemented (IIA 2009, 5).

These papers are ultimately indicative of how internal auditing can be involved in the creation of integrated reports for an organization. As explained in The Role of Internal Audit in Integrated Reporting: A South African Case Study, internal auditors are able to created integrated assurance reports about an entity that go beyond the financial statements (van Wyngaard and Steyn 2018, 2). This is especially true since the definition of internal auditing includes that the practice allows for outputs relating to risk management, governance, and control. The use of integrated reports, the authors argue, allows an organization to increase efficiency and effectiveness while reducing the risk of external threats (van Wyngaard and Steyn 2018, 3).

Finally, in Internal Auditing – Adding Value Across the Board, The IIA believes that an organization is best served by a fully resourced and professionally competent internal audit staff that provides value-added services critical to efficient and effective organizational management (2017, 1). This statement further increases the level at which the practice of internal auditing orients itself towards management. Additionally, the paper explains that internal auditors are partners to management – another management-orientated statement regarding the practice (IIA 2017, 2). This article additionally presents the idea that internal auditors are an integral part of the management team and are able to furnish the management team with information on the activities they review in practice (IIA 2017, 1). The authors further promote the management orientation of internal audit by stating that when internal audit is accepted and acknowledged by an organization’s leaders as management activity, internal auditors can better support management and the board in achieving organizational objectives.

Thus, as seen in The IIA’s own position papers and various other publications, modern internal auditing is certainly management-orientated and highly involved in management practices. How this orientation occurred is a result of the practice struggling to become a recognized and respected profession. Throughout the history of internal auditing, the internal audit function has had to prove its value to the organization and has struggled to separate itself from the usual stereotype that it was the assistant, provided by management, to the external auditor. In order to escape that stereotype, internal audit needed to differentiate the practice of internal auditing from both the practice of organizational management and the financial statement focus of the external auditor. Thus, it attempted to strike a balance between the two – by being an assurance and consulting practice that management could rely on for issues beyond financial matters and by being a function that external auditors could occasionally rely on.
Accounting Assurance to Adding Value for Management: A Historical Perspective

Pre-20th Century Practices

First, the beginnings of internal auditing and accounting must be understood. Around 7,000 years ago, formal record-keeping systems were used by organized businesses and governments in the Middle East in order to correctly account for receipts, disbursements, and tax collection. Ancient civilizations developed systems of checks and counterchecks to ensure the accuracy and completeness of their records. Thus, the role of the accountant expanded, especially in ancient Egypt. Dots, marks, and ticks were often seen at the side of figures, indicating that checks were performed on business records (Lee 1971, 151).

The city states of Greece used checking clerks to verify the business transactions pertinent to government entities (Lee 1971, 152). The Greeks, Romans, and Babylonians instituted a system of control over government activities to prevent errors and fraud from affecting their institutions (Ramamoorti 2003, 3).

Towards the end of the Middle Ages, businesses began to grow and standardized business structures were emerging. Some of these business structures, such as partnerships, required a better system of internal controls over resources and transactions (Lee 1971, 152). Luca Pacioli presented the work *Summa de Arithmetica* during this time, changing the practice of accounting forever. His work helped introduce the implementation of double-entry bookkeeping, which allowed people to gain better control and understanding over an organization’s transaction (Lee 1971, 156). The text also introduced the first inklings of oversight of internal controls, a glimpse of the coming responsibilities of an internal auditor. During this time, the financial duties of accounting would become so vast as a result of expanding businesses that a separate function would need to verify the accounting information used for decision-making by management (Ramamoorti 2003, 3). Thus, internal auditing was born.

However, auditing in general was not found to be a largely necessary practice before the industrial revolution in the United Kingdom, as most organizations were small (Teck-Heang & Ali 2008, 2). These small organizations were usually owned and operated by the same individuals, so the need for an independent team of individuals to overlook processes was not present.

Initially, the function was born out of the necessity to protect an organization from the financial consequences of fraud and otherwise lost assets. This role indicates how internal auditing was initially an accounting assurance practice. Internal audit’s scope would extend to all financial transactions and later to auditing operations. Eventually, internal audit would have limited roles and responsibilities over management issues in the 20th century. Here it is possible to see the beginnings of internal audit’s ability to add value for management beyond financial statements.

Early 20th Century: Pre-Institute of Internal Auditors

At the beginning of the 20th century, corporations became larger and more dispersed geographically, lending an environment that needed more sophisticated means of internal control. When the Great Depression came upon the United States, cost effective management and asset control became prevalent spotlights in firms who wished to survive. The Securities Act of 1933 and the Securities Act of 1934 established new regulations that specific firms were required to follow in order to practice their trades in the United States. The introduction of these regulations created new demand for expertise on internal controls to ensure compliance and prevent adverse legal action.
During this time, the recognition of internal audit as a specific function was stagnate, as was the self-propelled growth of the industry itself. However, as the clients of external auditors began to grow throughout the 20th century, external auditors and management alike needed to be able to complete an audit in a timely and cost effective manner. As a result, external auditors became more focused on assurance to outside investors and less focused on assistance to management, a role that ended up being filled by internal auditors (Parker and Johnson 2017, 50).

1941-1977: The IIA is Installed and the Practice Begins to Go Beyond the Books

The creation of The IIA in 1941 helped individuals to have a common organization to share ideas on the duties and responsibilities of practitioners of internal auditing. Additionally, the creation of a professional organization that recognized internal auditors for their unique work would allow for greater recognition across all industries of the practice of internal auditing. Around the same time, the perception of an internal audit function began to shift away from the conduct of the internal check into more dynamic activities such as consulting.

In 1947, The IIA formulated the Statement of Responsibilities, which allowed internal auditors to define their work as an appraisal service for both financial management and operational management (Parker and Johnson 2017, 54). Internal auditors then perceived themselves as systematic reviewers who formally reported on the matters that they audited.

A 1949 survey by T.W. Spicer would indicate a shift in the internal audit function’s responsibilities. Eight firms responded to the survey stating that the scope of internal auditing was broader than its traditional accounting and financial boundaries, extending to business practices and controls over other business processes (Parker and Johnson 2017, 53). H.L. Kellogg also noted that staff in an internal audit function began to evaluate the operations of a firm, further indicating a shift to adding value for management (Parker and Johnson 2017, 54).

A struggle within the internal audit profession is prevalent during this time period. The lack of independence the internal auditors had – due to many owing their employment to the organizations they audited – meant that the opinion of the internal auditor was not considered as credible as the opinion of the external auditor. Here, the practice of internal auditing sought new roles and responsibilities to be considered a separate profession in its own right (Parker and Johnson 2017, 54). The easiest way to differentiate the practice of internal auditing was to extend its scope by keeping the tools of controls and process evaluation and monitoring that it acquired in its role as an accounting assurance activity, but applying it as a service for management to help an organization meets its objectives.

As a result of this role switch, the Statement of Responsibilities was amended in 1957 to recognize an internal auditor’s responsibility to review any business activities for the benefit of management (Parker and Johnson 2017, 55). Additionally, many organizations used internal audit as a management training ground – a practice that may have hurt the internal audit profession (Parker and Johnson 2017, 56). Practice during this era emphasized on reporting to management. While this switch occurred, the majority of internal audit functions still based their educational credits on degrees in accountancy – not management. This is indicative of the accounting roots that the practice held and still holds onto.

In 1971, the Statement of Responsibilities was revised to broaden the auditor’s responsibility to include a formal grant from management for full access to all relevant business records of the organization –
thus, increasing the internal audit function’s ability to add value to management (Parker and Johnson 2017, 54). The addition of a formal grant allowed internal auditing to not only be recognized as its own profession, but also allowed it to better serve management with a formal access to a large scope of records.

J. T. Choi noted in his 1971 study that many internal audit functions spent much of their time completing operation audits, and the benefits of operational auditing were cited as helping the audit staff be seen as part of management and improved cost savings to management (Parker and Johnson 2017, 56). This survey is indicative of the changes within the field, an example of how internal auditors were going beyond the books to serve their organizations.


During this period of time, several business scandals rocked the United States economy. In particular, many multinational companies were investigated for questionable payments to foreign officials. Although external auditors were primarily blamed for not stopping such actions, internal auditors were also criticized. This was because many viewed that internal auditors had the ability to prevent such payments from occurring by performing their responsibilities as auditors (Parker and Johnson 2017, 59). The Foreign Corrupt Practices Act of 1977 (FCPA) required that public companies kept detailed and accurate records and devised and maintained a system of internal accounting controls. This act elevated the practice of internal auditing to a new light, as the review of systems of controls was the responsibility of internal auditors.

However, another shift in responsibilities occurred as a result of the passing of the FCPA. The FCPA moved functional responsibility for the internal audit function to the audit committee. As a result, internal auditors had to split their time between activities for the audit committee and activities for management. This shift indicated a move back towards internal auditing’s accounting assurance origins, as now both the board of directors, via the audit committee, and management were beneficiaries of the internal audit function’s work.

In 1985, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was organized by the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives International, the Association of Accountants and Financial Professionals in Business, and The IIA. The IIA’s participation in COSO at this time suggested a detour back to accounting assurance roots, especially since this increased The IIA’s affiliation with many accounting associations. However, this was not the case, as illustrated in the next time period.

1987-2000: COSO Illuminates Internal Auditing Just Before the Implosion of Arthur Anderson

COSO further emphasized the importance of companies maintaining internal audit functions and encouraged the creation of independent audit committees, strengthening the legitimacy of the internal auditing practice (Parker and Johnson 2017, 61). Professional internal auditing journals during this time focused on the idea behind adding value to the organization, and internal auditors were encouraged to expand their service offerings, granting special attention to risk management and evaluation. These attitudes encouraged the internal auditing practice to continue expansion towards being a management-orientated practice.
In the 1990s, internal auditors worked in several areas depending on their particular organization’s needs and preferences (Parker and Johnson 2017, 61). Internal auditors performed a variety of financial and operational reviews and audits for the benefit of the organization. The management of many organizations were entering the fierce global sphere of competition and were in need of improved quality and risk management initiatives in order to be able to compete at such a level. The value of internal audit functions in the eyes of management then increased, as the professionals in these functions were considered the most qualified group of individuals to monitor, improve, and evaluate the effectiveness of controls and operations.

21st Century Changes to the Craft and Concerns About Controls
The accounting scandals and implosion of Arthur Anderson LLP in the early 21st century contributed to the creation of the U.S. Sarbanes-Oxley Act of 2002. Sarbanes-Oxley details the requirement for publicly traded companies to have internal controls over financial reporting. Sarbanes-Oxley also reduces the ability for a public accounting firm to provide internal auditing and financial statement auditing services to the same client (Parker and Johnson 2017, 62). These boundaries allowed the profession of internal auditing to thrive within an organization and to provide more compliance services to management. However, many argue that this occurrence caused the practice to revert back to focusing on accounting-related services rather than expanding toward the broader role of management consulting that an internal audit team can provide. In 2006, the New York Stock Exchange began to require listed firms to maintain an internal audit function, increasing the internal auditing practice’s value to management.

As the profession has evolved, internal auditors have become more involved in the managerial aspects of the organizations they serve. Depending on the focus of the organization, many internal auditors have suggested in a recent interview that an in-depth knowledge of supply chain management is a highly valued asset to a young internal auditor (Interview 2019). Knowledge of supply chain management allows a young internal auditor to add value to management beyond a financial perspective. The IIA believes that an organization is best served by an internal audit staff that provides value-added services “critical to efficient and effective organizational management.” This statement is broad enough to imply that internal auditors should be able to oversee any and all business activities to ensure their efficiency and effectiveness. In order to do so, the practice has become more aligned with the idea of consulting clients on business processes.
Camouflaged Consultants

Over time, as business has changed, so has the practice of internal auditing. Up until the 1990s, internal audit attempted to meet the demands of both operational management and the audit committee by performing traditional operational audits (Parker and Johnson 2017, 51). Through these audits, assurance was provided to the audit committee that controls were adequate, that the organization was in compliance with pertinent laws, and that operations managers were assured that operating objectives were being achieved.

In order to provide added value as a function to the management of an organization, internal audit has turned to becoming in-house consultants for the organization. With the expertise that internal auditors possess on determining if business processes are effective and efficient, many can use their prior experience to consult management on best practices of controls over financial reporting and other business processes. This has been seen in practice, as clients not only want to learn the internal auditor’s opinion on a business process, but also value advice from the internal auditor on improvements (van Twist et al. 2015, 4). This is especially desired since internal auditors not only have the skills, knowledge, and insight on the assurance over business processes, but also are able to generate value by consulting on those business processes as well.

However, the practice of consulting is more than an accompanying activity for the internal auditor – it is another way that the internal auditor adds value to the organization. One must question, however, how consulting can be integrated within the internal audit profession appropriately. This is understandable, as auditing is considered a retrospective activity while the practice of consulting is forward-looking. One key dilemma that internal auditors face is the balancing act of being an assurer and a consultant, as assuring processes that one has consulted upon could be considered a threat to independence. This can be avoided by putting in place barriers to prevent such a thing from occurring, such as preventing internal audit from actually designing controls they would assure. Some consulting activities that internal auditors can participate in are displayed in Figure 1, which focuses on the responsibilities that the practice can undertake in enterprise risk management (IIA 2009, 5). The middle section of this chart is indicative of responsibilities of an enterprise risk management consultant.
There is also the issue of perspective on consulting – some internal audit professionals view consulting from an auditor’s viewpoint whereas some view consulting from the consultant’s perspective. For many internal audit professionals, consulting occurs as a result of the work that internal audit does in an assurance engagement. However, some business professionals argue that this limits the scope of consulting to simply what the internal audit function has engaged in (van Twist et al. 2015, 18). As a result, other business processes that may need attention are ignored. These processes could be areas that a separate consulting firm could focus its efforts on, however.

The best practice for internal auditors moving forward is to utilize the knowledge gained from an assurance engagement and provide consulting services for any portion of the assurance engagement that was in need of improvement. This way, internal auditors can provide a value-added service by not only performing a retrospective service, but also a forward-looking service that uses the retrospective information to determine what direction a firm should go. This allows a firm to add value to the organization in both the present and the future.

The best way for an internal audit function to properly balance its assurance and consulting services is to consider a self-assessment/certification strategy (Anderson 2003, 121). This allows the internal audit function to, regardless of where its focuses are, continue to retain its consulting services without overstepping its assurance responsibilities. Brad Rachmiel at Protiviti specifically recommends CAEs to stay grounded in their professional obligations in order to properly balance traditional assurance and new consulting services as well as meet the demands of different stakeholders (Rachmiel 2018). Rachmiel suggests that CAEs should use their rapport and interpersonal business skills to achieve this goal. One warning that Rachmiel provides is to avoid complacency, which can lead to failure. By avoiding complacency, one avoids being taken advantage of and violating one’s professional obligations.
Conclusion
Through the lens of history, it is easy to see how internal auditing has gradually changed. As time goes on, internal auditing has blossomed from a specific assurance practice to a value-added management-orientated practice involved in business areas far beyond accounting. As civilizations became more sophisticated, so did business and as a result, the practice of internal auditing. The 20th century lent itself to particularly crucial changes that would allow the profession to evolve into the practice that it is today.

As the practice evolved, internal auditors became consultants to management and were able to provide their expertise on business processes to increase the efficiency and effectiveness of the processes within their organizations. As the profession transitioned to this role, its respect as a profession in its own right grew and the value that the internal audit function provided to an organization was recognized. This is seen in the formalization of the profession through the creation of The IIA, several position papers that The IIA has released in recent years, as well as numerous changes to the Statement of Responsibilities that have allowed the practice of internal auditing to expand its ability to add value to an organization in both financial and nonfinancial aspects. These changes solidified the profession’s place in business and cemented the standards and practices of internal audit.

It seems inevitable at this point then that internal auditing is a practice that helps an organization look both backward and forward in its development to aide it in the present and the future. As internal auditing as a profession homogenizes, so does its common practices. The internal audit function then will become a channel that management can rely upon for assurance and consulting services – any areas that the internal audit function can provide assurance upon can also be consulted upon if necessary in order to increase the effectiveness and efficiency of the firm. This is perhaps the best way that internal audit, given its accounting roots, will be able to add value to an organization.
References


12. Interview with internal auditors with author, February 27, 2019.
