Essay Topic:

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

1. Describe the development of internal auditing from accounting assurance only to value adding for management.

2. Explain how internal audit has become a key advisor to management on aspects beyond finance and accounting.

3. Discuss the changing role of internal audit to consulting.

4. Address the balance and ability to perform both assurance and consulting on nonfinancial aspects.

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Cindy Beck
Birmingham City University, United Kingdom
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## Contents

Acknowledgments ........................................................................................................................................... 3
About the Author ........................................................................................................................................ 3
Introduction .................................................................................................................................................. 4
Defining Internal Auditing ................................................................................................................................. 5
Development of Internal Auditing from Accounting Assurance to Value-Adding for Management ......................................................................................................................................................... 6
Internal Audit: Key Advisor to Management on Aspects Beyond Finance and Accounting ..... 8
The Changing Role of Internal Audit to Consulting ......................................................................................... 9
Maintaining the Balance and Ability to Perform Assurance and Consulting Services ........ 10
  Maintaining a Balance Between Assurance and Advisory reviews ......................................................... 11
  Competencies and Skills of Internal Audit ................................................................................................. 11
Conclusion .................................................................................................................................................... 13
References ...................................................................................................................................................... 14
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About the Author

Cindy Beck, CIA, is a postgraduate student at Birmingham City University (United Kingdom) studying a master of science in internal audit management and consultancy. Born and raised in Guyana, Cindy began her career as an internal auditor at the Ministry of Finance.

Cindy holds a bachelor of accounting and finance from the University of Cienfuegos, Cuba. Following her master’s degree, she is planning to continue her career in internal audit and pursue the Certification in Risk Management Assurance (CRMA) and the Certified Public Accountant (CPA) qualification.
Introduction

“It is normal for any activity- including a control activity such as internal auditing- to come into being as a result of emerging needs.”¹

As a result of changes in organizational needs, technology, and complexity of the organizations’ activities and systems, the nature of the services sought from the internal auditors has been transforming over the years from an emphasis on traditional or compliance audit to a value-adding role for management. As internal auditing was mostly accounting-oriented at first, internal auditors’ responsibilities have gradually evolved to be management-oriented. The modern internal auditor is now considered to be a trusted business advisor to management and is expected to play a key role in helping the organization achieve its strategic objectives through various assurance and consulting activities.

The essay begins by defining internal auditing to understand its nature and appreciate the evolving role of an internal auditor within the organization. Secondly, it explores the changes that internal auditing has undergone from an accounting assurance only approach to value adding for management; noting that the modern auditor is a value-added tool for management in the form of an assessor, assurer, or advisor. Thirdly, the essay examines how internal audit has become a key advisor to management on aspects beyond finance and accounting: by being proactive in providing strategic advice, using subject-matter expertise to challenge current practices, being attuned to opportunities for enhancement, being a catalyst for change, among others. Fourthly, the essay explores the changing role of internal audit to consulting; noting that corporate scandals and the global financial crisis of the 2000s prompted internal audit to refocus their efforts beyond regulatory compliance to value-added consulting services. Lastly, the essay examines whether internal audit can maintain the balance and whether it has the competency to perform both assurance and consulting on nonfinancial aspects.
Defining Internal Auditing

To appreciate fully the evolving role that an internal auditor plays in helping organizations achieve their strategic objectives, it is important to first consider the nature of internal auditing and answer the fundamental question- what is internal auditing? The IIA defines the practice of Internal auditing as “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.”

The definition above had undergone several revisions since its first appearance. It traces its origin to the 1947 IIA Statement of Responsibilities of Internal Auditing where it pronounced that “Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.”

Decades later, the Auditing Practices Board, in its Auditing Guidelines- Guidance for Internal Auditors, 1990, offered the following definition: “Internal audit is an independent appraisal function established by management for the review of internal control system as a service to the organization. It objectively examines, evaluates, and reports on the adequacy of internal control as a contribution to the proper, efficient, and effective use of resources.”

Due to changes in the business environment, prompting complex business processes, innovations, and availability of information, the need for the internal audit profession to adapt to this new environment became evident and necessary. As a result, in 1997, a multinational group, consisting of practitioners, academics, and consultants, known as the Guidance Task Force (GTF) was assembled by The IIA to study the needs of the profession. Several perspectives of the internal audit profession were considered by the group, among them the definition of internal auditing. The group concluded that the prevailing terminology was insufficient as it did not adequately reflect the function of modern internal auditing and did not support its new role of providing consulting services.

Hence, in 1999, The IIA provided a new definition of internal auditing (first statement mentioned above), which embodies the modern features of internal auditing. It reflects the changes that have occurred in the auditing profession over time, recognizes internal audit’s key role in governance, risk management, and control activities, and acknowledges internal audit’s added responsibility of consulting services. It embodies a futuristic approach whereby internal auditors add value by continuously improving the operations of the organization.
Development of Internal Auditing from Accounting Assurance to Value-Adding for Management

Traditionally, internal audit was designed to safeguard an organization’s assets and assist in the preparation of reliable accounting information for decision-making purposes. However, over time internal audit’s focus has dramatically shifted from financial and compliance-oriented auditing and assets safeguarding to value-added assurance and consulting as the business environment became more complex.

Auditing in the form of checks and counting of records can be traced to the public financial systems of ancient Egyptians, Greeks, and Romans. During this period, auditing was limited to detail verification of bookkeeping records to locate fraud. Before 1941, internal auditing was basically a clerical function. Due to manual record-keeping, internal auditors were needed to examine the records for accuracy and errors, mainly to detect fraud. Essentially, they were performing similar functions to security officers as they were tasked with verifying records to safeguard the assets of the organization.

As business activities expanded in size, scope, and complexity, so did their bookkeeping systems. The necessity for not only external verification of the bookkeeping system, but also for an internal assurance function that would verify the accounting information used for decision-making purposes by management emerged. As a result, the internal audit activity was established around the middle of the 20th century and the internal auditors were delegated the responsibility of providing assurance on the accounting controls systems. Gradually, internal auditors were able to overstep their customary role of providing assurance on accounting matters and progress to providing assurance to management on all operational processes, including management’s activities.

Over the decades, the business environment experienced rapid and revolutionary changes (globalization, technological advancements, etc.) causing extensive impact to organizations across the globe. Increased business transactions, increasing dependence on technology, new market opportunities, changing regulations, and other developments created new risks and opportunities. Given this environment, management recognized the need for internal audit to play a larger role, one that expands on its traditional focus on testing internal controls related to financial reporting and compliance to encompass activities that relate to value creation. Due to its unique position within the organization and its extensive knowledge of the business and its operations, internal audit is well placed to serve as a proactive, value-added management activity that embraces a multitude of responsibilities.

As internal auditing was traditionally accounting oriented, its responsibilities were now management-oriented. Instead of just reporting on routine accounting issues found during their audits, internal auditors were now able to “question the overall control processes they were reviewing” and propose ideas to improve these processes and provide advice and insights that influence strategy.
Internal audit has evolved to be a value-adding activity, aligned with the business strategy to assist organizations to achieve their goals. This is consistent with The IIA when it defines internal audit as a value-added activity that helps an organization achieve its objectives, by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. The new definition shifts the focus of internal audit from an assurance activity to a value-added activity, giving the function a modern identity. Accordingly, the modern internal auditor is expected to add value to the organization by improving its operations by proactively supporting the board and management and by providing prudent advice on business improvements or enhancing existing processes.

Internal auditors, through their assurance and consulting services to the organization, contribute to improved organizational operations. In gathering data during their audit activities, they develop significant insight into the operations and observe numerous opportunities for process improvement or other enhancements that can be extremely beneficial to the organization (best practices, new approaches to risk detection, etc.). To add value through reporting, internal audit findings are effectively communicated to management, the audit committee, and others in an accurate, reliable, and timely manner. Internal auditors also add value by determining that the activities of the organization are being performed economically, efficiently, and effectively; by addressing existing and potential risks (with the use of a risk-based audit plan); by addressing corporate governance in their audit activities; by ensuring that the organization is up to date with the latest technology and processes; etc.

Lately, internal audit has begun to perform audit activities on an ongoing basis. With traditional audit practices, there is a delay (sometimes very significant) between the completion of fieldwork and the issuance of audit reports, making the reported information less valuable to the users. This new effort of continuous auditing which is technology-driven enables internal audit to prepare audit reports without delay, provide management with real-time information, offer valuable suggestions due to active involvement in the business, and contribute to continuous improvements within the organization.

Internal audit as a value-added activity also considers the performance of audits only when the benefits exceed the cost, use of technology in its audit activities, use of appropriate audit approach, and active involvement within the organization (at the business unit or process level, management level, audit committee level, etc.).

It can be appreciated that internal audit has remarkably evolved from the primary role as a financial and compliance-oriented activity and has become one of the most important means of establishing and delivering value for the organization.
Internal Audit: Key Advisor to Management on Aspects Beyond Finance and Accounting

Historically, internal audit has been considered as a monitoring function, the organizational policeman or watchdog, performing mainly controls assessments. It had limited role in assisting management to achieve major corporate objectives. Today, internal audit is considered as a value-added tool in the form of assurer, assessor, and advisor. Its advisory role within organizations is paramount and evident, especially in today’s global business environment.

The current business world operates in a complex, rapid, and evolving environment. It is characterized by economic and political uncertainties, new market and product opportunities, technological advancements, changing customer expectations and behaviors, changing work place environment, among others. This changing phenomenon has prompted a paradigm shift in the activities performed by internal audit, resulting in the function playing a key role in helping organizations achieve their strategic objectives.

Management and the audit committee rely on internal auditors’ opinions and seek their advice. Accordingly, they have emerged as a key means of giving management and the board the confidence and strategic support to respond to the challenges and opportunities of the dynamic business environment. They are now expected to play an essential role by providing guidance to management in addressing strategic and potential risks, reengineered structures and processes, and other management strategies. This is evident in the broad range of responsibilities being performed by internal auditors today, expanding from the customary operational and financial audits to include audits in areas of business strategy, risk management effectiveness, value for money, governance and many more.

Traditionally internal audit has been known to operate behind-the-scenes, assisting audit committees to perform their duties and “serving as a management watchdog.” However, the changing business climate required internal audit to be more than its conventional watchdog or compliance checker over the organization’s operations.

While assurance activities will always be internal audit’s main function, advisory services are essential to the effective and efficient performance of the organization’s operations. To become a trusted advisor and not just a watch dog to management, internal auditors should be “proactive in providing strategic advice,” use their subject-matter expertise to challenge current practices, be attuned to opportunities for enhancement, and be a catalyst for change. They must look beyond the processes and controls and provide strategic insights that improve business performance, provide ideas that challenge existing operations and identify recommendations to address existing and emerging risks that matter.

For internal audit to achieve the transformation, it needs to:

- Align the goals of internal audit with the key stakeholders.
- Report regularly and use key performance indicators (KPIs) to report progress.
- Assume a leadership role in coordinating the second and third lines of defense.
- Build a high-performance team.
Invest in technology.
Become a trusted advisor to the audit committee and executive management.

Lately, there has been a great surge in the demand for internal auditor services in areas such as environmental, health, and safety; quality-control; ethical and social responsibilities; and other areas. To meet these growing demands and be acknowledged as trusted advisors to management, internal auditors need to possess the necessary skills and competencies of the profession. In addition, they need to be adequately resourced and be appropriately positioned within the organization with sufficient organizational authority. Today, due to its transformative role from oversight function to delivering insight and foresight, internal audit has established itself as a competent and valuable tool to the organization.

The Changing Role of Internal Audit to Consulting

Internal audit, like any control activity evolved because of emerging needs. As stated previously, internal audit was traditionally designed to safeguard an organization’s assets and assist in the preparation of reliable accounting information for decision-making purposes. However, due to the increasingly complex business environment, changing stakeholder expectations, newer perspectives on risk management, and demands from management and regulatory authorities, internal audit has witnessed a considerable transformation in its functions.

Despite having ancient roots, internal auditing was not recognized as an important process by organizations until the 1930s. The world had just experienced an economic depression (with extensive impact to organizations) and as a legislative corrective measure, the United States Securities and Exchange Commission required organizations registered with it to provide audited financial statements. This resulted in organizations establishing internal audit activities primarily to assist the independent auditors who at that time were focused on expressing an opinion on the fairness of the financial statements. During this period, internal auditors’ primary role was performing reviews of accounting records to detect financial errors and irregularities. The early internal auditors were considered as clerical personnel due to their routine tasks.

Over the decade, the operations of organizations increased in volume and complexity, creating control issues for management over their business activities and operational efficiency. Due to the expansion in business transactions, it was no longer feasible for internal auditors to carry out audit assurance by reperformance. As a result, by the 1940s, internal audit had extended its purview to providing assurance to management about the systems of internal accounting control.

In the years following the establishment of The IIA in 1941, internal auditors were still viewed as part of external audit and were thus requested to assist them with financial statement reviews, accounting reconciliations, etc. During this period, internal auditors had minor roles within organizations and limited responsibility in management areas.
In 1944, Arthur E. Hald, one of the founders of The IIA, made the following statement:

“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.”

This declaration materialized because within the second half of the 20th century, internal auditing was one of the fastest growing professions in the world. The world’s economies experienced accelerating growth within this period and marked important development in technological advancement. Organizations expanded globally, and their operations became more complex. Accordingly, management needed assurance that the activities of the organization are being performed economically, efficiently, and effectively. Gradually, internal audit scope included all operational areas and internal auditors took on more responsibilities in the management spectrum. The roles of internal auditors were changing due to changes in the world.

Corporate scandals and the global financial crisis of the 2000s prompted internal audit to refocus their efforts beyond regulatory compliance (control focus) to value creation (performance focus) to assist the organization in achieving its objectives. While internal audit is still considered as the right hand of management in assuring that policies, plans, and procedures are adhered to, they now also fulfill a consulting role. In addition to identifying best practices and identifying risks that threaten the organization, internal auditors also assist the organization in reducing redundant and inefficient processes. They have an increasingly important role in the overall risk management efforts of the organization, in assisting the organization achieve its objectives, and as trusted business advisors to the organization and its stakeholders.

Today, internal audit has moved beyond its traditional role of providing assurance on historical activities and is currently providing assurance and consulting services in all operational areas of the organization, establishing itself as a valued and respected part of the management effort.

**Maintaining the Balance and Ability to Perform Assurance and Consulting Services**

The business environment is constantly changing and with it, the audit committee and management’s expectations of internal audit. This has prompted an increase in audit activities being performed by internal auditors and has also changed the types of audit services being carried out. In striving to add value to the organization, internal auditors provide various assurance and consulting engagements to the organization. The type of audit performed depends on their organization’s needs and preferences. Some of the activities carried out are compliance audits, audits of transaction cycles, environmental audits, information technology audits, process reengineering facilitation, internal control training, and other assurance and consulting activities.
Given the various assurance and consulting activities being performed by internal audit and the growing demand for their services, two important matters to consider are whether internal audit can balance performing both assurance and consulting services, and whether internal audit has the ability to perform both assurance and consulting services.

Maintaining Balance Between Assurance and Advisory Reviews

Due to the changing business environment, management and the audit committee want more than reliable assurance and efficient audits. They want audits that are proactive, insightful, and future-focused that lead to organizational performance improvements. Given its unique position within the organization and subject-matter expertise, internal audit can expand its role to offer advisory services. However, internal audit still needs to continue to preserve value (control focus advisory audits) for the organization.

To perform a mix of assurance and advisory activities, internal audit needs to find the right balance. Internal audit should be compliance-focused to determine that operations are performing efficiently and effectively, but it also needs to be adding value to the organization. Hence, finding the right balance is important. It is not always easy to achieve balance. The extent of audit work undertaken by internal audit is based on budgeted resources. As a result, the amount or type of consulting work performed may be restricted due to lack of resources (personnel, finance, technology, etc.), lack of internal audit competencies and skills, time restrictions, etc.

Due to their active involvement within the organization, internal auditors are aware of the current issues affecting the organization or the potential risks that it faces. Therefore, audits are planned for in advance and can include both assurance and advisory reviews. The audit plan should also budget for time delays due to unexpected issues that may arise.

Internal audit also needs to create an audit plan that addresses both the expectations of the audit committee and management and the key risks of the organization. This planning process will be able to include an appropriate blend of advisory and assurance engagements. The plan should be reviewed and updated regularly to identify emerging risks. Internal auditors also add value when they are involved at the beginning of major change initiatives or processes. They address risks early on and can influence better outcomes.

Competencies and Skills of Internal Audit

As the role of the internal auditor evolves and stakeholder expectations rise, internal auditors increasingly require competencies beyond their traditional skill sets.

The modern auditor needs to be competent in interpersonal communication skills, negotiation skills, team building skills, among others. It is also vital that internal auditors master analytical and critical thinking skills, have knowledge of available technology-based audit tools, understand the business (business acumen), and have awareness of risks and opportunities faced by both the client and the auditor.
It is important that internal audit identify the skills it has, the skills needed, and where the gaps in competencies are. To fill the gap, internal audit needs to invest in training, co-source from professional service providers, and recruit to have the necessary talent, mix of skills, and experience to meet the expectations of its stakeholders and provide the appropriate level of assurance. Internal auditors also need to be assertive to obtain relevant information for audit work. In addition, they should have a good working relationship with other assurance providers within and external to the organization and should not be afraid to challenge management.  

Internal audit can also adapt to the changing environment by aligning its activities with the strategies and goals of the organization. Internal audit with the right set of competencies can help an organization achieve its business objectives by identifying weaknesses and opportunities for improvement.

To assist internal auditors in keeping up with changes in their environments, The IIA developed the Common Body of Knowledge (CBOK). The Internal Audit Foundation also developed a Competency Framework for Internal Auditors (CFIA) to provide internal auditors with guidelines regarding their knowledge and the competencies needed to stay in touch with the changing business environment. In addition to these materials, internal auditors have at their disposal the *International Standards for the Professional Practice of Internal Auditing* which has among its purposes: to provide a framework for performing and promoting a broad range of value-added internal auditing services. The necessity for internal auditors to maintain independence and objectivity while performing assurance and consulting activities are addressed within the *Standards*.

The modern internal auditor is formally and actively serving the audit committee, and the chief audit executive has direct and frequent communication with the committee. This reflects “the major progress in the scope of internal audit’s coverage and level of service to all areas of the organization.”
Conclusion

Originally developed as a means of assisting organizations to safeguard corporate assets and enforcing policies to preserve value, internal audit has expanded its traditional role with a new focus on value creation. Decade by decade, it has been able to move beyond its compliance-focused or watchdog role for management. The modern internal auditor is considered as a value-added tool for management in the form of assurer, assessor, and advisor.

While assurance activities will always be internal audit’s primary function, advisory services are essential to the effective and efficient performance of the organization’s operations. Internal auditors create value and are considered as trusted business advisors to management because they are proactive in providing strategic advice, use their subject-matter expertise to challenge current practices, are attuned to opportunities for enhancement, and, overall, act as a catalyst for change.

Modern internal auditors have an increasingly important role in the overall risk management efforts of the organization, in assisting the organization achieve its objectives, and as trusted business advisors to the organization and its stakeholders.

To perform a mix of assurance and advisory activities, internal audit needs to find the right balance. In addition to having a compliance-focused approach (preserve value), it also needs to be adding value to the organization. Internal audit adds value by including both assurance and consulting services in its risked-based audit plans, which are regularly reviewed and updated. As the role of the internal auditor evolves and stakeholder expectations rise, internal auditors increasingly require competencies beyond their traditional skill sets. Internal audit with the right set of competencies can help an organization achieve its business objectives by identifying weaknesses and opportunities for improvement.

Today, internal audit has moved beyond its traditional role of providing assurance on historical activities and is currently providing assurance and consulting services in all operational areas of the organization, establishing itself as a valued and respected part of the management effort.
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