CHAPTER 3
THE INTERNAL AUDIT FUNCTION: AN INTEGRAL PART OF ORGANIZATIONAL GOVERNANCE

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I. Introduction

Chapter 1 provides considerable discussion on the evolution of the internal auditing profession over the last 60 years. To better understand and position internal audit in the context of contemporary global organizations, a conceptual framework containing several organizational governance issues is introduced in this chapter. Furthermore, this conceptual framework serves as a road map to key topics presented in the remainder of the monograph. Relevant authoritative standards from the newly issued Professional Practices Framework are cited to support, clarify, or expand upon this new role for internal audit.

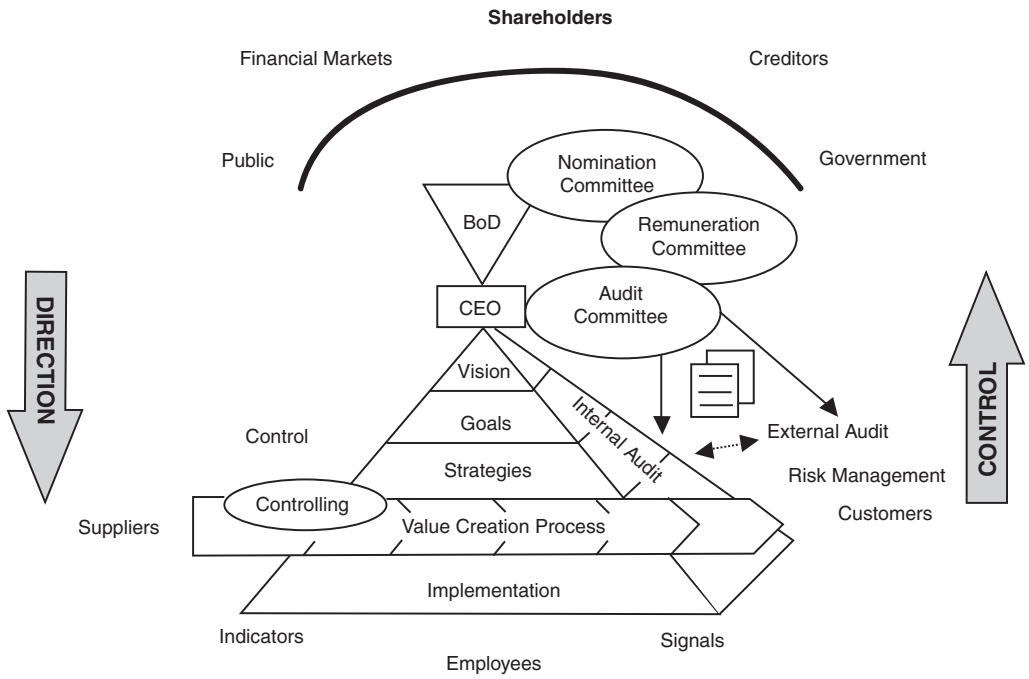
II. The Core of the Conceptual Framework

An early governance study, the Cadbury Report (1992), defined governance as the "system by which companies are directed and controlled." Similarly, discussed in the ROIA chapter by Hermanson and Rittenberg, other definitions of governance have emphasized the structure through which objectives are set, and how these are achieved and monitored. As Exhibit 3-1 shows, based on the strategic direction formulated by the top management and the board of directors, the organization develops specific objectives and goals attempting to turn the broad direction into operating, process-oriented, value-creating measures. To ensure these transformation processes, a thorough understanding of the risk threatening the whole organization or elements thereof is needed. Further, different control measures with indicators and signals are installed to measure specific performance, indicate necessary correction, and provide feedback to the operating management as well as to the top management and the board in aggregated form. The controller reports on process performance, the external auditors examine the financial accounting, and the audit committee engages in assuring the provision and reporting of internal and external information. Finally, the organization furnishes its shareholders and stakeholders with financial and operational information for continued decision-making.

Within this direction and control loop, the internal audit function takes on important roles of organizational governance, integrates several other governance and control aspects, and stands out as *the* most important, single mechanism for ensuring adequate and effective organizational governance.

The rest of the chapter describes these relationships in more detail. Any of the indicated relationships can be subject for in-depth studies and a number of research questions are provided to exemplify relevant research areas.

Exhibit 3-1
Internal Auditing in an Organizational Governance Framework



(Source: Ruud & Bodenmann, 2001, p. 522)

Understanding the Organization and its Objectives

Based on the strategic direction of an organization — defined in a *vision* and a *mission statement*, management develops and implements agreed-upon, realistic, and attainable business strategies and performance goals. Strategies indicate how an organization intends to achieve its objectives, while goals translate objectives to a measurable and achievable level. Many factors influence the operation of an organization and, consequently, determine which objectives the organization can reasonably seek to accomplish. Factors such as the type of operations, the organizational size and structure (e.g., centralized versus decentralized organization structure), or the capital base and structure, including compensation schemes (e.g., total share capital and debt employed, privately held versus public company, stock-

based compensation and incentives) all influence the organizational objectives and capabilities.

An in-depth understanding of an organization's objectives- and goals-hierarchy is a prerequisite for every successful internal audit function. The alignment of the internal audit function's objectives with the organization's goals is also explicitly recognized in *Standard 2010*, these factors strongly influencing the nature, scope, and purpose of the internal audit function.

> "The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, **consistent with the organization's goals**." (emphasis added)

This top-down organizational objective hierarchy is illustrated graphically in Exhibit 3-1. It indicates how an organization — at best in congruence with the expectations of its stakeholders — chooses its desired strategic directions, how these objectives and goals are turned into operating measures, and how they become important parts of organizational governance. Decisions as to changing the organizational structures and operations as well as developments in management and organizational practices influence the organizational governance. Understanding these organizational relationships thus also forms the basis for structuring an effective internal audit function.

Developments in Management and Organizational Philosophy and Practices

Many recent, and ongoing, developments in management and organizational philosophy and practices have important implications for today's contemporary internal audit function.

Web of Relationships. Advances in global communications technology have transformed today's multinational companies into virtual communication networks. Organizations today are largely networked, extended enterprises that look "boundaryless," prevailing business models in B2B and B2C commerce feature supply chain management (SCM), customer relationship management (CRM) initiatives, and a host of arrangements of strategic alliances, outsourcing arrangements, co-branding and cross-branding efforts, as well as other affiliations. This has also been remarked by Kiernan (1996, p. 6). "The organizational architecture of German industrial giant Daimler-Benz is becoming increasingly typical: 'the company' now includes not only its permanent in-house employees, but also strategic alliances (IBM, Mitsubishi), joint development and production initiatives (Thomson and Fiat), and cross-stakeholdings (Deutsche Bank, Saab, Banque Nationale de Paris). It is increasingly difficult to tell where companies begin and end, and there's less and less point in trying to do so."

Indeed, organizations seem involved in an intricate web of relationships — they are consequently accountable to an ever-expanding stakeholder constituency, that is, they owe responsibility to numerous parties or groups affected directly or indirectly by the organization's actions and decisions.

Outsourcing Non-Core Functions. Organizations focusing on what they deem to be their core competencies tend to exhibit a strong preference for outsourcing of non-core business functions (Rittenberg & Covaleski, 1997, p. 1) In such contexts, the internal audit function is less concerned with assuring the steps of the (internal) business processes, but instead devotes more attention and resources to ensuring that the negotiated outsourcing contracts are yielding the expected level of service quality, are being met timely, and are cost efficient. This is exemplified by the new *Standard 2110* and *2120* stating that compliance include those of laws, regulations, and contracts.

Soft Controls. An emphasis, in many organizations, on "softer" organizational values, ethics, and culture changes the control form as well as structure (COSO, 1992). The relevant question in this context is: "How should internal auditors audit business processes and aspects where the controls have shifted and compliance of guidelines and policies can no longer be audited in a traditional way?" Control risk self-assessment is one method for providing assurance by putting more emphasis on self-evaluation on the part of managers and employees as process-owners.

Reengineering. Organization-wide reengineering, involving "a fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical contemporary measures of performance such as cost, quality of service, and speed," is becoming commonplace (Gupta, 2001). These management-driven business process redesigns and enhancements have had significant implications for the internal audit function, which was charged with monitoring the change management efforts and providing feedback as to whether they were successful.

Role of the Internal Audit Function. In today's business environment, the internal audit function has become a major support function for management, the audit committee, the board of directors, the external auditors, and other key stakeholders. When properly designed and implemented, the internal audit function can play a key role in promoting and supporting effective organizational governance. This is depicted in Exhibit 3-1 by the overarching "umbrella" where some of the stakeholders are mentioned. *Standard 2130* defines governance processes as "the procedures utilized by the representatives of the organization's stakeholders (e.g., shareholders, etc.) to provide oversight of risk and control processes administered by management." The internal audit function certainly fits within this definition.

A Process-Oriented View of Value Creation and Risk Management

A key element of the new definition of internal audit is the focus "designed to add value and improve an organization's operations" (IIA, 2002). Given today's complexity in an organization's business activities, as well as of its business environment, the management of isolated business activities and the negligence of the relationships between them have not proven successful. Rather, a process-oriented management approach that integrates the whole "value chain" (Porter, 1985) — or the "value network" or "value shop" (Stabell/Fjeldstad, 2000) — is necessary to ensure an organization's viability and prosperity. One of the main business principles in this approach is the enhancement of customer satisfaction for both internal and external customers. This is depicted in Exhibit 3-1 by the horizontal value-creating process, ultimately linking the customers' desires with the transforming processes and vendors through procurement.

In order to provide most value-adding services, the internal auditing function needs to assume a process-oriented audit approach as well (Roth, 2002). Indeed, given the organization-wide in-depth knowledge internal auditors accumulate throughout their careers, they are particularly familiar with an organization's value creation and are therefore ideal consultants for the improvement of an organization's processes. The improvement of internal processes is likely to have a positive effect on suppliers and customers (e.g., cost savings, reduced production times, improved quality of products), thus the internal audit function is also able to add value to external parties. Assessing information all along the value creation process, the internal audit function contributes to more reliable and relevant information than if isolated information is evaluated. This also allows an improved relationship and cooperation between the internal and external auditors and leads to more effective organizational governance (see also Felix, Gramling, & Maletta, 1998).

A disciplined approach to value creation requires an organization to manage all significant and likely risks effectively. Risk can be considered both at the macro or portfolio level (enterprise-wide risk management) as well as the micro or departmental level. In Exhibit 3-1, risk management is indicated on the right side of the pyramid, and can be performed internally or externally. Important to realize, however, is that the ultimate responsibility for conducting risk management remains with top management and the board.

Just as crucial as it is to understand an organization's goals, is it crucial for an internal audit function to understand the risks that either threat the achievement of objectives and goals (*Standard 2110)* or that fail to identify and explore new opportunities for the organization. Internal auditing is therefore expected to apply an integrated, process-oriented approach to the evaluation of risks in order to evaluate both upside and downside risks. Apart from

understanding risks, the internal audit function needs to assess risk management processes in order to determine whether structure, functioning, and control processes are appropriate to manage the identified risk factors. Assurance Standard 2010.A1 states:

> *"The internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. The input of senior management and the board should be considered in this process."*

Over the last few years, The IIA Research Foundation has released several excellent publications on the topic of risk and risk management, viz., McNamee & Selim (1998), the Tillinghast-Towers Perrin Study on Enterprise Risk Management (2001), and more recently the study by Walker et al. (2002). The internal audit function's role in risk management is explored further in the ROIA chapter by Kinney.

III. Organizational Governance

Organizational governance can be understood in the context of the needs of and the relationship to the stakeholders of an organization. The IIA *Standards* define governance processes as "the procedures utilized by the representatives of the organization's stakeholders (e.g., shareholders, etc.) to provide oversight of risk and control processes administered by management."

Organizational governance has changed fundamentally over the last decade due to numerous large business failures, some of them in the wake of massive management fraud. Huge financial losses have led to an increasing focus and demands on organizational structure from investors, creditors, and other constituencies. In this context, it has become important to inquire as to how organizations assure that planned activities and guidelines are in fact being implemented and are functioning as intended. Internal audit functions can take on important roles in providing such assurance, thus promoting organizational governance.

Internal Stakeholders

The board of directors, top management, operational management, and employees as main internal stakeholders have direct responsibility for the organizational activities.

Shareholders and investors charge **the board** and **top management** with the responsibility of managing their invested funds. Direction and control are top management's main instruments to assume this responsibility (see Exhibit 3-1). **Middle management's**

responsibilities are primarily defined at the operational level. Middle management redefines strategies and objectives defined by top management as organizational goals, which are further broken down into key performance indicators and signal systems. These key performance indicators and signal systems can be analyzed in order to ensure the proper functioning of systems and processes, and to eventually answer the question as to whether the organization functions as intended. **Employees** perform operational activities. However, given trends such as a higher knowledge level of employees, empowerment, enhanced automation or in-line controls, management can increasingly delegate control activities.

The **board of directors,** as a special group of internal stakeholders, is mainly charged with the definition of the overall strategic direction and with the supervision of operational activities. The board of directors should be adequately diversified and have a sufficient number of qualified members, without being too large for efficient decision-making. Two types of board systems are prevalent — the two-tier or dualistic system with a "management" and a "supervisory" board (e.g., found in continental Europe and particularly in France, Germany) and the one-tier or monistic system with one "board of directors" found, for example, in the UK and U.S. Several countries feature board systems with elements of both the monistic and the dualistic type.

The board of directors is commonly divided into subcommittees in order to take advantage of the board members' special knowledge, experience, and expertise. Typical committees are the **nomination** and the **remuneration** (or compensation) as well as the **audit committee**, the latter being most important in the context of internal auditing.

The audit committee functions as the coordinator between the external, financial audit, and the internal audit function as well as other assurance functions (e.g., risk management, compliance, code of conduct, legal matters, etc.). Typically, the audit committee is mandated with the financial monitoring (Blue Ribbon Committee, 1999). An interesting feature in some organizations is that the audit committee has a broader responsibility and oversees both operational and financial aspects of governance. An excellent example of this is the Swiss pharmaceutical company, Hoffmann La Roche, where the audit committee coordinates both financial and operational issues, while a separate "financial committee" considers the financial aspects.

To be able to assume its role as representative of shareholders' interests, the board of directors is supported by different organizational functions, e.g., risk management, organizational compliance, and organizational controlling and organizational security that help ensure the existence of adequate and effective governance. Risk management has gained widespread acceptance as mentioned earlier. Typically, the function is positioned high in the organization,

often reporting directly to the CEO. Offering an enterprise-wide, comprehensive risk analysis, the internal audit function can base its own planning on risk management's results. The organizational compliance function is typically located at the board secretary level and focuses on compliance of legal and regulatory issues. In addition, depending on the structuring of the organization, functions such as organizational controlling and organizational security as well as other organizational bodies such as information security can offer assurance to internal and external stakeholders. A close relationship of the described functions with the internal audit function can lead to better cooperation between assurance functions and offer a higher level of organizational assurance. For the purpose of this report, these activities are not being further considered here; however, several research issues as to the relationship of the differing functions can be identified and explored. The conceptual framework in Exhibit 3-1 illustrates these potential relationships.

Depending on the organizational structure, the audit committee organizes and coordinates further governance promoting activities such as the risk management, corporate compliance, corporate controlling, and corporate security. A key issue here is that the internal audit function can take on varying assurance assignments to improve organizational governance.

External Stakeholders

An organization faces different groups of external stakeholders, i.e., shareholders, financial markets, customers, suppliers, regulators, government, neighbors, and the public at large. These stakeholders are not directly involved in the business activities, but have an interest in the activities of the organization (ref. *Standard 2130*). Further, they influence the organization through their decision-making (for example, shareholders influence the market valuation of companies, or financial creditors offer or restrict credit).

Offering assurance — as to the functioning of the organization — to these external decision-makers is an issue of utmost importance as organizations struggle to make themselves attractive to investors, creditors, suppliers, and customers. As explained, the internal audit function can contribute effectively to improve governance in several aspects.

To **investors**, the issue is to ensure capital availability and liquidity as well as keeping the cost of capital within reasonable ranges. By offering assurance on information and on operational processes, the internal audit function can contribute in analyzing the needs for capital and liquidity, reduce the probability of a capital and liquidity squeeze, as well as provide creditors and investors with assured information as to the standing of the organization. It is to be expected that the cost of capital should be lower in a company where a high level of assurance is offered as compared to a company with higher uncertainty and risk.

To **suppliers**, the main focus is to stay as an attractive partner, which can negotiate favorable conditions.

To **customers**, a primary interest lies in the delivery of products and services that satisfy their needs in a timely and economic way.

Further external stakeholders such as the **public at large** and the **government** have other interests. Through development of regulations, supervision of their compliance as well as the judicial processes against potential infringement, the government plays several roles of significance to organizations. The pressure from the national and local government is not to be underestimated and, consequently, this importance should be understood.

Different stakeholders may have very different needs for information and assurance. Furthermore, between the organization and the stakeholders, there are different potential conflicts of interest. For example, the organization may not want to supply certain types of information to a financial creditor because of a potentially higher interest rate. Or similarly, investors may want more and assured information to make a "buy-or-sell" decision.

Many of these potential situations can be explained through the concept of an "asymmetric information" situation where the manager has better in-depth knowledge and understanding than the organizational body supervising him or her. In order to alleviate this "information bottleneck" situation where some people are better informed than others, internal or external assurers such as the internal audit function can offer assurance to the decision makers that the information is factual and correct.

The asymmetric information issue can also be exemplified between a one-tier (monistic) and a two-tier (dualistic) board of directors system. In situations where the chairman of the board also functions as CEO, the person has superior knowledge, which mostly is efficient for the daily business and decision-making. However, the supervisory role of the board is lacking and becomes more of a challenge.

The internal audit function can take on a more extensive role in systems with adequate and effective organizational governance. A key issue in this context is how the role and function of the internal audit function differ under the two systems of boards. This could be studied empirically across organizations as well as across nations with varying governance systems.

IV. Role of the Internal Audit Function in Promoting Effective Governance

In order to analyze what the internal audit function can offer, it is important to understand the needs and expectations of the internal and external decision makers toward the internal audit function. Also, different industries have varying needs for assurance services. For example, banks and insurance companies typically define the objective of the internal audit as one with primary focus on assuring the money flow, i.e., monitoring and supervising processes in order to prevent monetary losses and safeguarding assets. On the other hand, the manufacturing industry and the transportation sector has for some time used a more operationally oriented audit approach, as reengineering and process improvement within the areas of supply chain management, customer relationship management, production, marketing, accounting etc., were undertaken. A third group would be the public sector, which focuses on serving the public at large and the individual citizen. Obviously, these different sectors have different desires for assurance and thus needs for different internal audit services. Depending on the needs and desires of the organization and users, the internal audit function can take on different roles.

Interesting in this perspective is to consider recent organizational trends and how organizations function in a modern management and organizational perspective. These issues were discussed in the *Competency Framework for Internal Auditing (CFIA)* (Birkett et al., 1999), as well as in the preceding analysis (cf., e.g., Porter, COSO).

The Formulation of the Role of the Internal Audit Function in the Audit Charter

Understanding the role and the functioning of the internal audit function begins with an in-depth understanding of the organizational objectives- and goals-hierarchy. *Standard 2010* states:

> "*The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.*"

The agreed role of the internal audit function needs to be linked closely to what the organization is doing and must be formulated in the audit charter (Purpose, Authority, and Responsibility). *Standard 1000*, Purpose, Authority, and Responsibility, states:

- *The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the Standards, and approved by the board.*

- *1000.A1 - The nature of assurance services provided to the organization should be defined in the audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances should also be defined in the charter.*

- *1000.C1 - The nature of consulting services should be defined in the audit charter.*

The internal audit function is the single most important internal assurance provider. It is essential for top management and the board to employ the available assurance functions in an optimal fashion, i.e., to evaluate how and what each assurance function contributes to the overall desired assurance level. In addition to the responsibility of the chief audit executive, this is to be decided upon by the relevant organizational level such as top management or the board. *Standard 2050* says:

> "*The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.*"

This standard relates to the external audit function, but internal assurance providing functions such as risk management and corporate compliance can similarly contribute effectively to total assurance coverage.

Positioning of the Internal Audit Function

Among other functions within an organization, the position of the internal audit function is fairly unique in terms of: (1) its advantageous position *within* the organization, (2) the wide range of functional areas that it examines as well as the different types of audits capable of being performed, and (3) the multidisciplinary backgrounds of individual auditors comprising the internal audit team (Rittenberg & Schwieger, 1997). These desirable features continue to exist in most in-house functions and co-sourcing arrangements, but are somewhat diminished in the context of full outsourcing of internal audit services. Nevertheless, in every situation, the organizational status, positioning, and independence of the internal audit function is of paramount consideration.

Most importantly, a complete and sound understanding of the governance structure of the organization is a precondition for establishing an effective and independent[1] internal audit function Mautz (1964, p. 471) presciently observed: "The matter of independence is always a difficult one for an internal auditing function. It will of necessity report to someone within the company organization and therefore lacks the final degree of independence possessed

by public accountants. On the other hand, if it reports to an appropriate level of authority within the enterprise, it can well have sufficient independence to make itself effective." Accordingly, in order to ensure that the internal audit function can operate effectively and achieve the desired results, it is tantamount that the mandate is given from an adequately high organizational level. An optimal structure is achieved when the chief audit executive (CAE) reports directly to the audit committee (rather than the chief financial officer), alternatively, directly with the board of directors. This structure is indicated in Exhibit 3-1 with a clear reporting line to the audit committee. Another solution is the direct relationship with the chief executive officer; however, such a positioning makes the effective supervision of the CEO difficult and may increase the information asymmetry problem.

Internal auditors should refrain from assessing specific operations, and to avoid conflicts of interest, they have to be objective and independent (*Standard 1100*). The independence of internal auditors is a professional obligation to fulfill "an objective, unbiased, unrestricted opinion, and to report matters as they are rather than as some executive would like to see them." (Sawyer, 1996, p. 63). In this connection, Rittenberg & Schwieger (1997, p. 758) usefully observe that the internal auditor frequently confronts "difficult practical and ethical situations when there may be a conflict between loyalty to the company and the need to dissociate themselves from undesirable or even potentially illegal activities." A fuller examination of the concepts of independence and objectivity in the context of internal audit functioning appears in the ROIA chapter by Mutchler.

Internal Audit Activities: Assurance and Consulting Services

The internal audit function offers two main services: assurance and consulting services. **Assurance services** are defined as "providing an independent assessment on risk management, control, and governance processes of the organization. Examples may include financial, performance, compliance, system security, due diligence engagements" (*Standards*, Glossary). To provide the described assurance services internal auditors need to be independent and objective, implying integrity, competence, due care, and ethical behavior.

Assurance services differ from **consulting services** in that the latter are "Advisory and related client service activities, the nature and scope of which are agreed upon with the client and which are intended to add value and improve an organization's operations." Examples include counsel, advice, facilitation, process design, and training" (*Standards*, Glossary). These aspects are addressed in the ROIA chapter by Anderson.

The nature of work of the internal audit function (according to *Standard 2100*):

> *"...is to evaluate and improve the effectiveness of the following three processes:*
>
> - *Risk management processes — identification and evaluation of potential risks that might affect the achievement of objectives of an organization and determination of adequate corrective actions. A link can here be made to critical success factors.*
> - *Control processes — policies, procedures, and activities which ensure that risks are kept within the limits defined by management in the risk management process.*
> - *Governance processes — procedures which allow stakeholders to evaluate risk and control processes defined by management."*

The internal audit function can thus contribute both by evaluating the systems' functioning and reliability (assurance services) and supporting the design of these systems by providing specific recommendations (consulting services). The services actually provided by the internal audit function depend on the positioning in the organization as well as on its intended function.

Internal audit can contribute to effective governance in several ways. First, it can assist in the identification of risk factors, the analysis of the consequences, as well as in assisting management in the prioritization of risk management and control systems. Internal audit can add assurance that the risk management processes in fact are functioning as intended. Through consulting services, the internal audit function can furthermore assist management and the board by improving risk management and control processes.

The internal audit function can then assume an important role as an in-house advisory function that offers analyses and assurance to the board as to the functioning of the risk management and internal control systems.

Relationship with the Independent Public Accountant

An important cooperation of assuring information lies in the coordination of the external and internal audit function (see Exhibit 3-1 for the direct relationship). Although the external auditors mostly carry out the audit of the financial statements, internal auditors can contribute greatly through business, process, and activity knowledge as well as profound understanding of the risks facing the organization. In this way, the external auditors can conduct their audit more efficiently and provide a higher assurance level.

Felix et al. (1998) characterize the general current status of the relationship between the internal and external auditors as follows:

"1. Internal and external auditors independently develop and then share information on risk analysis.
2. Some attempts are made to coordinate audit plans.
3. When joint auditing is performed, the external auditor typically determines when and where such joint activities take place."

However these authors point out that the quality of communications between the two groups can be enhanced and that internal audit participation and assistance at the consolidated financial statement level can further be optimized. This coordination of different audit functions (internal and external audit) is known as total audit coverage.[2] Clearly, this is one area where existing governance structures and processes can be reviewed and further optimized for the benefit of all parties concerned.

Knowledge, Skills, and Competencies Needed for Fulfilling the Internal Audit Function's Role

Derived from the defined and agreed role, the internal audit function needs to analyze how it can fulfil its role with its competency and capacity. Due personnel planning represents the basis for an optimal staffing of the internal audit function. Apart from external recruitment, internal auditors are commonly recruited from within the organization. The organization can encourage employment in the internal audit function by using it as a "stepping stone." That is, serving in the internal audit function can, for example, be a requisite for further advancement and as grooming for leadership positions within the organization. Some of the personnel issues for the internal audit function, including hiring the best recruits from outside or from within the organization, on-the-job training and professional development, mentoring, and other matters regarding the management of the internal audit function, are covered in the ROIA chapter by Prawitt.

An important question as to the role and status of the internal audit function is who provides what activities (internal audit's nature of work — risk management, control, and governance) and the type of service (assurance or consulting services). Even more often the internal audit function draws capacity and competency through in-sourcing or co-sourcing. Potential providers here are the large accounting firms, consultancies, business service providers, and others. The issue is then how the organization ensures that it achieves sufficient assurance from internal and external assurance providers. If it turns out to be insufficient resources in terms of capacity and/or competency for the internal audit function, necessary skills through in-sourcing and/or co-sourcing can be obtained.

A related topic as to who is providing the internal audit services is the cost of the internal audit function, especially in the case of employing external service providers. Commonly, the internal audit function is regarded as a fixed cost pertaining to a separate function within an organization. With the introduction of new and more flexible organizational forms, and by contracting with external firms for in-sourcing, co-sourcing, or outsourcing, the costs of the internal audit function can be classified, at least partly, as a variable cost. It would be an interesting research project to investigate why some organizations regard the costs of the internal audit function as fixed, while others classify them as variable.

In terms of questions regarding capacity and/or competency, a current research topic is to consider the developments in the market for externally provided internal audit services. Regulators in countries such as Brazil and the U.S., citing the dangers of compromising auditor independence, have introduced rules prohibiting public accounting firms from offering internal audit services to audit clients.

Systematic Process of Internal Auditing

The characterization of internal auditors as professionals makes the adoption of a disciplined, systematic approach to conducting an audit a natural expectation from internal audit practitioners. Similarly, internal auditors are assumed to have adequate training and experience to exercise sound professional judgment when the circumstances require so. Further, a unique advantage of the internal auditing profession is that it is standards-based. The newly issued *Professional Practices Framework*[3] only underscores The IIA's commitment to raise the profile of internal auditors, provide authoritative guidance, and generate confidence in the quality of their work within organizations. As such, it is extremely important that internal auditors base their work on documented, rigorous approaches and methodologies that can be defended if their work is ever questioned by any of the organization's key stakeholders. Many of these issues are discussed in the ROIA chapter by Lemon and Tatum.

The central importance of experience and the interaction of judgment with professional expertise are captured in several works devoted to understanding, evaluating, and improving "professional judgment." Indeed the exercise of judgment is not only essential to the practice of disciplines such as law, medicine, and accounting, but is also what distinguishes these domains as professions (Boritz, Gaber, & Lemon, 1987, cited in Gibbins & Mason, 1988). In an environment calling for greater accountability for professional judgments, the basis for the exercise of professional judgment is increasingly coming under scrutiny (Ramamoorti, 1995).

In addition to carrying out research with the aim of understanding, evaluating, and improving professional judgment, it is also important to consider the use of decision aids and technology-based tools for conducting more efficient and effective audits. This may include the use of statistical sampling applications, ACL, IDEA, Microsoft Excel, CAATs, and other information systems auditing tools, as well as regression analysis and other statistical techniques. The IIA's *Systems Auditability and Control* (SAC) product from the 1970s has been updated to accommodate the needs of e-commerce, and the eSAC guidance is now available online. More recently, innovations such as Benford's Law for identifying errors and discrepancies, as well as the use of artificial intelligence techniques such as neural networks (see Ramamoorti & Traver, 1998), have made their debut. It should be noted that data warehousing procedures go hand-in-hand with data mining applications, and internal auditors with an eye toward the future need to gain familiarity with this burgeoning but highly relevant literature in computer science, database management and applications, expert systems, and artificial intelligence.

The professional internal auditing environment continues to be dynamic, uncertain, and complex, and has continually dictated that internal auditors gain industry specialization. Internal auditors are specializing by gaining industry-specific experience and/or by qualifying for specialty designations in governmental auditing, control self-assessment, or financial services.[4] This trend toward more proliferation of certifications and designations is likely to continue. What is required today is a combination of both experience and industry expertise, and internal audit practitioners are struggling to cope with the resulting information overload. In this connection, The IIA's *Professional Practices Framework* supplemented by the periodic issuance of Practice Advisories and other Guidance are helpful to the chief audit executive and the practitioner. This is an area in which academics interested in the internal auditing profession can play pioneering roles in advancing the goals of education, research, and practice.

V. Summary

This chapter of the ROIA monograph has attempted to demonstrate the important relationships between the internal audit function and other organizational units. The exhibit introduced initially in the chapter graphically shows these relationships and issues presented throughout the chapter. In each and every one of these relationships, interesting research topics can be identified and explored. In the Appendix to this chapter, several relevant research questions are outlined.

VI. Appendix I: Chapter Research Questions

Organizational Governance

- How does the structure of the board of directors influence the organizational governance and the role of the internal audit function? What are the differences between the unitary vs. the dualistic board system and its effect on the internal audit function and organizational governance?

- What national differences are there to the structure and role of boards of directors?

- What is the role of the internal audit function in establishing and ensuring effective organizational governance?

- How can the internal audit function best contribute to reduce information asymmetries between internal and external stakeholders?

- How will recent developments in organizational governance influence the role of the internal audit function? What will be the change in audits and focus?

- Which communication channels are the optimal ones to create between the board and the internal auditors? For example, how often and to what board members (audit committee) should the internal auditors report to ensure adequate and effective organizational governance?

- What is (are) the potential impact(s) of having the internal audit function report to different organizational levels (e.g., board of directors in general, audit committee, the CEO, the COO, the CFO)?
  1. In terms of the impact on the effectiveness of organizational governance.
  2. In terms of the impact on other organizational issues.

- For the outsourced internal audit function, does communication between the board and the internal auditors differ?

Internal Audit Function and Structure

- What are the current trends of the structure and content of internal audit charters? What changes were performed after the introductions of the new definition? How do these trends differ across countries?

- Have there been changes in independence/objectivity with the introduction of the new definition of internal audit? Is the discussion independence vs. objectivity changing the role of the internal audit function?

- What national differences are there to the structure and role of internal audit function?

- Are communication processes for internal audit functions performing consulting services different from those functions primarily offering assurance services?

- How is the coordination between the internal audit function and other assurance or "organizational governance" functions (e.g., risk management, organizational compliance, external auditing)? What is the best practice?

The Internal Audit Activity

- What are the consequences of changing the "scope of work" to the "nature of work" for internal auditors (from the 300 Standards to the 2100 Standards):
  1. How is the role of the internal audit function affected?
  2. How does this change the needs for changing competencies of the internal audit?
  3. Which consequences are to be identified for the audited organization?

- What is the level of assurance offered?

- How does the emphasis on "soft" factors (competency, trust, understanding the importance of culture, ethics, moral, etc., replacing detailed guidelines and regulations, teamwork and transparency) influence the internal audit activity? For example, one could assess the importance of change in management and organizations, or how empowered organizations function and what the effects on internal audit are. Further, in-depth understanding of the organizational goals and objectives and the value drivers replace formal communication.
  1. What are the effects of organizational changes on the structuring and assignments of the internal audit function?
  2. How do auditors have to base the audit in an empowered organization? How in case of a changing control environment?
  3. How do auditors have to audit the ethical climate and the "softer issues" of the organization (importance, methods, effects, and consequences)?

- Why do some organizations regard the costs of the internal audit function as fixed, while others classify them as variable?

- Why are there differences in the internal audit function across industries? A comparative study as to the differing roles of the internal audit function in industry sectors (for example, banking vs. industry or transportation sector).

Relationship between Internal Audit, External Audit, and Other External Services Providers

- What is the relationship between external and internal auditors and the audit committee?

- What is the consequence of recent developments as to the market for externally provided internal audit services, such as CPA firms having to stop offering internal audit services to external audit clients due to the independence?

- What is the nature of coordination between the internal audit function and other assurance or "organizational governance" functions (e.g., risk management, organizational compliance, external auditing)? What is the best practice?

Footnotes

[1]The notion of independence as it is construed with respect to internal and external auditors is different. An external auditor must be independent, in fact and in appearance, in the eyes of those outside the organization that place reliance on the external auditor's opinion on the financial statements. An internal auditor, on the other hand, must be seen as independent and objective by those who rely on his or her work inside the organization, viz., management and the board of directors (Rittenberg & Schwieger, 1997).

[2]For further information about total audit coverage, see Felix et al., (1998).

[3]The recently issued title in the IIA Handbook Series, "*Implementing the Professional Practices Framework*" by Chapman & Anderson (2002), is an important resource for practitioners and educators.

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