

An overview of the profession and how the Institute of Internal Auditors has advanced its interests over the past 50 years.

The Changing Roles of the Internal Auditor

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The year 1991 marked the fiftieth anniversary of the Institute of Internal Auditors (IIA). It is indeed a very short period of time in the history of internal auditing if one is told that the antecedents of internal auditing go back as far as the first days of accountability. Given such ancient roots, to many outside observers, the Institute of Internal Auditors (IIA) and the organized profession of internal auditing may appear to be no more than infants. However, a brief review of the history of internal auditing suggests that the IIA's fiftieth anniversary marks the end of the most important era in the history of internal auditing. In those 50 short years the internal auditor has grown from a "spare person", or a "clerical handyman", to a "partner with management" in helping the organization to achieve its goals efficiently and effectively. The purpose of this article, which focuses on the chronological development of internal auditing, is to provide a perspective on where the internal auditing profession is today, how it got there and where it is likely to be headed in the near future.

Early Internal Auditing

During ancient times, auditing as a discipline was concerned with governmental and family units. For example, A.C. Littleton, in his book *Accounting Evolution to 1900*, notes that the Chamberlains of the City of London were audited as early as 1298 by a committee composed of certain government officials[1]. The government officials of the City of Pisa were audited in 1394 to detect any defalcation of public funds. During these times, the primary objective of auditing "was to verify the honesty of persons charged with fiscal responsibilities"[2]. According to Dittenhofer[3], during this period the auditors were appointed or elected by the community at large and were expected to be competent and proficient in recognizing fraud and errors or omissions. It is interesting to note that these audits involved "hearing the accounts" since only a few could read and write.

According to Adelberg[4], during the sixteenth to eighteenth centuries the feudal period began to degenerate and auditing expanded in scope to include the transactions of a business-oriented society. In this regard, Littleton comments that:

With the advent of business, there came, instead of "accountability," the accounting of problems attendant upon the ownership of property and the calculation of profit and losses. Auditing shifted from checking on an individual's "stewardship" to scrutinizing written records and the testing of entries by documentary evidence[1].

During these 200-300 years, auditing revolved around the objective of fraud detection and prevention. Detailed checks were performed and each transaction was traced back to the supporting source documentation. The auditors, during this period, were not only required to be competent and proficient in recognizing fraud and errors or omissions, they were also expected to have book-keeping skills and a great deal of professional judgement.

Internal Auditing from 1900-1940

According to Kent[5], the first change in internal audit concepts came in the early 1930s. During this period, the Securities and Exchange Commission (SEC) required that firms willing to register with the Stock Exchange must provide audited financial statements. The external auditors, during the same period, were starting to place greater emphasis on expressing an opinion on the fairness of financial statements based on a sample of transactions rather than on the "usual" detailed verification of all the transactions. These changes prompted many corporations to establish internal auditing departments, primarily to fill the void created by the independent auditor's emphasis on sample audits. In this role, internal auditors were expected to work under the independent auditors and thereby assist them in carrying out financial audits effectively. As a result of this increased attention, internal

auditing in most corporations during the 1930s was a shadow of independent auditing.

Internal Auditing after 1940

The formation of the Institute of Internal Auditors (IIA) in 1941 with 24 charter members was largely due to the pioneering efforts of John B. Thurston, the head of the internal auditing department at North American Company[6]. He also became the Institute's first president. The formation of the Institute marked the start of a "journey of 1,000 miles with one step" by a group of forward-looking internal auditors. Their objective: to professionalize the field of internal auditing.

Within a few years of its formation, the Institute made remarkable progress in establishing itself as an influential body to promote the professional interests of internal auditors. It initiated many conferences and public meetings, emphasized the communication of research in internal auditing by starting a new journal titled *Internal Auditor*, and published several monographs on internal auditing to help its members. These efforts succeeded in increasing the membership base of the Institute as well as generating public awareness of the internal audit function.

According to Chambers *et al.*[7]: "In the pristine semi-professional days the IIA pursued its course by issuing a series of *Statements of Responsibilities of the Internal Auditor*, starting in 1947", and revising them periodically in 1957, 1971, 1976, 1981 and 1990. The several revisions indicated that "there was nothing fixed or final about these statements. Internal audit was evolving constantly, and they therefore represented a fair and considered statement of the present state of development"[7]. A review of the definition of internal auditing as provided by various *Statements of Responsibilities of the Internal Auditor* reveals significant changes in the scope of internal auditing over a period of almost four decades. A brief summary of the *Statements* is provided in Table I.

Vinten[8] has appropriately characterized this development by observing that at the time of issuance of the first *Statement of Responsibilities of the Internal Auditor* in 1947, the operational audits were an afterthought and therefore were relegated to the status of an "appendix". However, in 1957, at the time of first revision, operational audits were promoted to co-equal partnerships and, by 1971, at the time of second revision, operational audits had clearly taken over.

Besides issuing several revisions to the *Statement of Responsibilities of the Internal Auditor* and the *Standards for the Professional Practice of Internal Auditing*, the IIA has also issued seven *Statements on Internal Auditing Standards (SIAS)* from July 1983 to June 1989. These statements discuss and provide guidance to the modern internal auditor on various aspects of their work. A brief

Table I. Summary of the Various Statements of Responsibilities of the Internal Auditor

Statement	1947	Primarily accounting and financial matters. Also may consider operating matters as a basis for protective and constructive service to management
	1957	Reviews accounting, financial and other operations as a basis for service to management
	1971	Reviews operations as a service to management
	1976	Unisex! All pronouncements are now sexless
Standard	1978	Emphasizes service to the organization rather than to management
Statement	1981	Independent appraisal activity to assist members of the organization
	1990	Independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization
Adapted from[7].		

summary of various *Statements on Internal Auditing Standards* is provided in Table II.

In addition to these SIASs, the IIA, over the years, has also issued several *Professional Standard Bulletins (PSBs)* in question and answer form for providing information and clarifications to its members on a number of topics important to internal auditors. A review of the several PSBs and Table II indicates that the modern internal auditor, in addition to investigating and detecting the fraud, also evaluates internal controls and overall organizational controls. In addition, the internal auditor also provides recommendations for future actions based on the analysis, communicates regularly with the board of directors and co-ordinates with independent auditors to ensure that external audits are carried out efficiently and effectively.

Table II. *Summary of the Statements on Internal Auditing Standards*

SIAS No. 1	July 1983	Control: Concepts and Responsibilities: Requires that internal auditor examines and evaluates the planning, organizing, directing processes to determine whether reasonable assurance exists that organizational goals and objectives will be achieved
SIAS No. 2	July 1983	Communicating Results: Suggests that the report should include recommendations for potential improvements
SIAS No. 3	May 1985	Deterrence, Detection, Investigation, and Reporting of Fraud
SIAS No. 4	November 1986	Quality Assurance
SIAS No. 5	June 1987	Internal Auditors Relationship with Independent Outside Auditors: Suggests that internal auditor should co-ordinate with the independent auditor to ensure adequate audit coverage and minimize duplicate efforts
SIAS No. 6	December 1987	Audit Working Papers: Provides guidance on maintaining effective working papers
SIAS No. 7	June 1989	Communication with the Board of Directors: Suggests that the internal auditor regularly attend and participate in board meetings related to oversight responsibilities, internal audit department budget and its independence in the organization

Today, several other interest groups, such as the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Controllers Institute, the Institute of Management Accountants (IMA), and the International Federation of Accountants (IFAC) recognize the Institute of Internal Auditors as a well-established professional organization by inviting it regularly to participate in their summit meetings. Today's internal auditor has a code of ethics and is known by a professional designation: *Certified Internal Auditor*.

As a result of the cumulative efforts of the Institute, internal auditing is now characterized by an extension of the audit examination into activities of an entity that were not previously audited. These boundaries have expanded to include an examination of the overall performance of an enterprise as well as its management. The contemporary internal auditor not only attempts to detect fraud and examines financial records of an organization but also determines whether the organizational plans and activities have been carried out economically, efficiently, and effectively. In addition, he or she comments on whether organizational objectives as set by the management have been achieved. This expanded scope of internal auditing is also referred to as "operational auditing", "management auditing", "strategic auditing" and "economy and efficiency auditing". No matter what the name is, the contemporary internal auditor is well-versed to assist the management to the extent of being indispensable.

A Look to the Future

Many more changes are in store for the internal auditor in the coming years. The internal audit function will continue to expand to meet demands of the changing business environment and the internal auditor will be subjected to increased interaction with other line functions and outside groups. In the following pages, we discuss five important areas of activity which will affect the future of internal auditing:

- Automated Manufacturing Systems (AMS) environments;
- proactive auditing;
- increased co-ordination with external auditors;
- computer sophistication;
- rigorous quality assurance programmes.

Automated Manufacturing Systems

Corporations worldwide are currently facing an environment characterized by accelerated technological change, shortened product life cycles and global competition. Corporations are responding by investing in Advanced Manufacturing Systems (AMS) and implementing production systems such as Just-in-Time (JIT) and computer-integrated manufacturing. In addition, corporations are recognizing the inadequacies of traditional cost accounting systems that use labour hours as the basis of overhead allocation and provide "after the fact" reports about variances that can no longer be corrected. Currently, Activity-based Costing (ABC) is being implemented as a supplementary costing system that overcomes the deficiencies of the traditional system.

The implementation of activity-based costing should be carefully monitored for it to be effective. Ray and Gupta[9] discuss the following types of internal audit involvement

that would lead to successful implementation of ABC in the new manufacturing environment:

- audit of cost drivers;
- treatment of common costs;
- audit of non-financial performance metrics;
- assessment of product development;
- audit of value added by activity-based costing.

McReynolds and Fern[10] discuss what internal auditors should do to keep pace with advanced manufacturing systems. They suggest that:

internal auditors should be integrally involved in the earliest stages of the transitions to AMS. Internal auditors must understand both the underlying philosophies of AMS (better quality, shorter production schedules, and reduced costs) and how they will alter traditional considerations, including physical facilities. Reporting goals will include better and faster cost monitoring, more relevant cost assignments, and evaluation of total costs incurred over a product's life, as opposed to traditional manufacturing only costs. . . . internal auditors must understand the broad concepts and objectives of AMS, as well as the unique role of the internal audit staff.

Much the same conclusions were reached in the Institute of Internal Auditors Research Foundation monograph *Internal Auditing in a Just-in-Time Manufacturing Environment*[11] by Barefield and Young:

We believe that if internal auditors are to be instrumental in the operational evaluation of JIT and JITP, they must understand how these systems operate. Production environments are changing at such an incredible rate that unless internal auditors immediately begin acquiring such knowledge, they will be left without a significant role in this transformation. Further, many organizations view JIT as an intermediate step toward more advanced technologies such as computer-integrated manufacturing (CIM) and so called "lights out" factories. Thus, internal auditors must have a very current understanding of these technologies.

The internal auditor should in future take a more participatory role in setting up and maintaining the automated manufacturing systems and monitoring the cost accounting systems that go with them. The internal auditor in future must play the role of a change agent by supporting the introduction of new ideas and participating in their implementation.

Proactive Auditing

In future, the internal auditor will increasingly be engaged in proactive auditing. Menkus[12] discusses the arguments in favour of proactive auditing:

Proactive auditing is, for example, inherently more cost-effective than a so-called "cycle auditing" strategy. Ideally, a proactive auditing strategy adds value to information asset management while helping to prevent possible loss. It avoids an over concentration on the technical and punitive aspects of the audit process. At the same time, a proactive approach

to auditing places a needed emphasis on assisting in management's efforts to make the organization's information systems activity more effective.

Basically, proactive auditing entails the internal auditor's active involvement and participation in all systems development activities, including development of internal control systems. This approach runs against the current perception of the internal auditor as an appraiser only. However, the idea of proactive auditing deserves attention as it is very similar to Total Quality Management (TQM), one of the recent developments in manufacturing quality control. Total quality management advocates have emphasized that investments in "prevention costs" (front-end quality control) offset downstream "appraisal costs" (quality inspections of the finished product). If the objective of organizations is to have effective internal control systems, then front-end proactive auditing will serve a purpose similar to TQM. The investment in early involvement of the internal auditor in setting up various controls in the organization will generate substantial savings in the subsequent use of internal audit resources used in appraising these controls in future.

The internal auditor will move away from the prevailing practice of cyclical audits

The internal auditor in future will move away from the prevailing practice of cyclical audits and engage in more proactive auditing where they will work jointly with other teams to implement change and set up a wide variety of control systems for different applications. Such an approach should lead to better utilization of audit resources and yield more effective internal control systems.

Co-ordination with External Auditors

Leonard Berry[13], in a 1983 study sponsored by the IIA, notes that total audit costs (both external and internal) have risen significantly during the past two decades due to the increased complexity of the business environment. This increased audit cost has motivated audit committees and the management of major corporations to search for better ways to enhance co-operation between the internal and external auditors. As a result of this growing awareness, the Auditing Standards Board and the Institute of Internal Auditors have taken several measures in the form of SAS 9, "The Effect of an Internal Audit Function on the Scope of the Independent Auditor' Examination"; SAS 61, "Communication with Audit Committees"; SIAS 5, "Internal Auditor' Relationship with Independent Outside Auditors" and SIAS 7, "Communication with the Board of Directors". Note that currently a proposed SAS

entitled "The Auditors' Consideration of the Internal Audit Function in an Audit of Financial Statements" is under consideration by the Auditing Standards Board. If issued it will supersede SAS 9.

Although these pronouncements have resulted in increased co-ordination and co-operation between internal and external auditors, a great deal remains to be accomplished. Ward and Robertson[14], in an attempt to find the extent to which independent auditors rely on the work of the internal auditor, reported that 50 per cent of the CPAs and 45 per cent of the internal auditors surveyed felt that internal auditors were not relied upon to the fullest extent possible. The increased co-operation in future will certainly lead to *total audit coverage* and a greater degree of assurance to the management on the financial as well as operational aspects of the organization. The increased co-operation, besides reducing the audit fee bill of the corporation, would also result in the following significant benefits to external and internal auditors:

Benefits to external auditors:

- better insight into client operations through the experience and knowledge of internal auditors;
- improved client relations due to a feeling of involvement;
- availability of time to concentrate on more significant areas without causing an audit delay;
- enhanced professional training for the independent auditors by working in a multi-disciplinary audit team.

Benefits to internal auditors:

- enhanced training for the internal auditor by working in close contact with the CPAs;
- identification of areas needing further work or improvement within the company;
- a better understanding of the standards and objectives of the independent auditor.

According to Fred Newton[15]:

An agenda for the 1990s should harness the various audit functions to avoid duplication of common tasks and to increase the overall efficiency and effectiveness of audits. . . Auditing standards have addressed interactions between auditors in certain circumstances (in the use of internal audit tests of internal controls; specialized assistance for elements of an audit; and consultation with technical advisors; as examples) . . . we should (now) explore means of going beyond the present practice.

Computer Sophistication

An increasing number of corporations are investing huge amounts in data-processing equipment to automate their financial and operating systems. The data-processing

systems are becoming increasingly complex. As a result, corporate managements and audit committee boards are calling upon internal auditors to take an active part in the System Development Life Cycle (SDLC) of their computer systems. They are requiring that internal auditors provide an independent evaluation of system effectiveness by examining:

- the match between system capabilities and organizational needs;
- on time installation;
- within budget costs or cost overruns;
- adequacy of operating and financial controls;
- system maintainability.

In addition, internal auditors are increasingly expected to be able to audit under a number of EDP environments, such as service centre, microcomputer environment, batch systems, distributed systems, on-line and real-time systems and database systems.

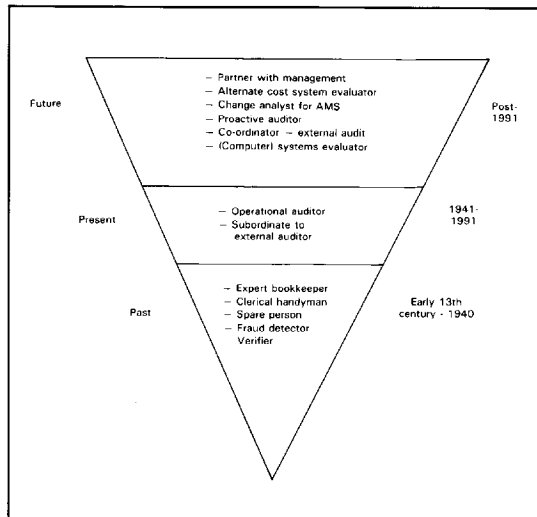
As the environment of various corporations becomes more computerized, so does the need for the internal auditors to audit within that environment. The internal auditor of the future, while auditing data-processing systems should not only ensure that corporate policies and procedures are complied with, and frauds detected, but should also audit systems controls, systems reliability and its cost-effectiveness. In this regard, Reeve[16] observes that:

In the future, internal auditors will have a strong working knowledge of electronic data processing, so that audit tests can be conducted more efficiently. The software programs used in audits will be designed especially for the performance of audit tests of the data banks. Internal controls, such as limiting factors and cross-checks to other data files, will be built into the software programs used by management.

Quality Assurance Programmes

In future, internal auditors will be subjected to rigorous quality assurance programmes. In the new automated manufacturing systems environments using JIT or CIM, corporations are using activity-based costing systems to distinguish between value-added and non-value-added activities. Activity-based costing provides reports that help to identify departments/products using a high proportion of non-value-added activities. Identification and reduction of non-value-added items (for example, move time, set-up time, wait time, etc.) support the TQM philosophy. These concepts have the potential of being applied to service functions such as internal auditing. With respect to TQM, Fred Newton[15] observes: "Total Quality Management (TQM) . . . is the idea of having things done right by those responsible and avoiding the costs of review and rework. The concept certainly applies equally in the audit services environment."

Figure 1. *The Changing Role of the Internal Auditor*



In the future, the ABC systems currently being applied in manufacturing will be applied to the internal audit function. Reports containing the breakdown of audit activities will be scrutinized for the proportion of non-value-added activities. Therefore, systems that reduce oversight and supervisory reviews will be installed. Such a rigorous quality assurance programme will seek continuous improvement through the elimination of non-value-added activities.

Conclusion

The establishment of the Institute of Internal Auditors has provided a great impetus to the professional upgrading of internal auditors. The practice of internal auditing has matured and developed greatly during the 50 years of the IIA's existence; the internal auditor has certainly come a long way. Figure 1 provides an overview of the evolving role of the internal auditor. The growth in internal auditing is in no way expected to remain at today's level; the role of the internal auditor will continue to expand at a rapid pace in the coming decades and beyond. Chambers *et al.*[7] have aptly summarized this outlook for the future:

The future is exciting but depends on the diligence and conscientiousness of the individual internal auditor, and the work of the professional bodies. There is no room for passengers, but with a committed army of auditors there is much scope for achievement.

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