

Internal Audit Reporting Relationships: the Analysis of Reporting Lines

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Initially created as an accounting oriented function internal auditing has been transformed into management oriented profession. If at the beginning internal auditors were seen just as assistants of accountants and external auditors, nowadays it is certainly an independent profession, which is playing a significant role in the management of organizations. Internal auditing evolved to satisfy the needs of a management of organizations. Private companies as well as government institutions have become so difficult, large and complex that their managerial line became concerned about monitoring and controlling activities that are in their responsibility. Internal auditors may assist management in many areas.

Broad scope of internal audit functions and roles emerged year by year. Initially internal auditing was basically concerned with accounting and financial matters. Although first Statement of Responsibilities published in 1947 by the Institute of Internal Auditors challenged to tap operating matters, however it emphasized the role of internal auditing in accounting and financial issues. Statements of Responsibilities issued later by the Institute of Internal Auditors help to track the development of internal auditing profession: from accounting oriented function up to management oriented, sophisticated and value added discipline.

Obviously reporting relationships of internal auditing has changed and developed together with the progress of internal audit discipline. At the beginning (when internal auditors mostly were dealing with accounting and financial issues) reporting lines of internal auditors went to the accounting level and external auditors, who saw internal auditors mainly as assistant in financial audits. Accordingly as functions and roles of internal auditing expanded, changed and shifted more to management oriented matters than accounting matters, reporting lines have also been transformed. Moreover, if at the beginning reporting lines of internal auditing were generally simple and straightforward, together with changed functions of internal audit they have made a shift to more complex and difficult relationships. Of course, due to the fact that internal auditing is internal function of organizations, most constituents (customers) of internal audit services are members of companies or institutions, such as senior and operating management or audit committees. Because interests and needs of these customers differ, internal auditing frequently faces potential conflicts of internal audit concerns and reporting. One customer usually is interested mainly in assurance services (i.e. audit committee), another group is concerned about consulting services and recommendations (i.e. operating management) and the third group may be paying attention to both services of assurance and con-

sulting (i.e. senior management). Of course these interests of the customers of internal audit services may interfere and one group of customers may shift their concern from one service to another.

Internal audit reporting lines usually are classified to administrative or functional. According to the Practice Advisories of International Standards for the Professional Practice of Internal Auditing, ideally the chief audit executive should report functionally to the board or audit committee and administratively to the chief executive officer of the organization. However as the results of the research provided in this article show reporting lines of internal audit activity are not always organized as they should be ideally.

Keywords: *internal audit, internal audit services, internal audit reporting relationships and reporting lines, audit committee*

Introduction

Disputes about the internal audit relationships have never turned out since the first appearance of the internal audit. During the emerging phase of internal audit profession the scope of internal auditing and the reporting lines were quite straightforward. Sawyer (2003) has described internal auditing as the “eyes and ears of management.” Internal auditors had to investigate operations in order to assure that they were properly controlled and make recommendations to the management. It was presumed that recommendations would be similar to what management would have done if management had the time to individually review all operations for adequate controls (The IIA Research Foundation, 2003).

Definition of the internal auditing provided by the Institute of Internal Auditors states that “internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”.

This definition identifies an important role for internal auditing, which is based on the activities in which it has a defined expertise. At the same time, it recognizes that there are many different customers (constituencies) for internal audit services. Such (internal) customers of the internal audit services in organization may be excluded:

- Senior management
- Operational management
- Audit committees and the board of directors.

Due to the fact that different customers of internal audit services may have different interests, potential conflicts may rise serving these customers. For example, senior management may be interested in activities, which may directly affect the bottom line in the profit (loss) account, i.e. potentially their bonuses. On the other hand, operational management may be interested only in recommendations on improving the efficiency or effectiveness of operations. Audit committee may be more concerned with managing their own risk and request a greater focus on risk management and control activities.

The purpose of this article is to observe reporting relationships of the internal audit activity taking into consideration the roles and functions of internal auditing, review possible threats and conflicts related with reporting lines and explore the results of the research in the context of theoretical assumptions.

Review of published literary sources, graphical analysis of survey results and other methods are used in order to formulate conclusions. The issue of internal audit reporting relationships is analyzed in the context of systematic approach. This approach is developed by proceeding from theoretical problems formulation to the interpretation of results of empirical studies.

An overview of the assumptions of the activity of internal auditing

As it was mentioned above, internal audit has experienced significant transformations since its appearance. These transformations refer to the status of internal audit activity in the organization and broad range of internal audit functions, which currently covers many areas. Nowadays, internal audit activity covers many functional areas:

- Assessment of internal controls
- Operational audits
- Compliance audits
- Fraud investigations
- Partial or full participation in financial audits
- Involvement in risk management process
- Other activities.

Wide spectrum of areas, covered by internal audit, determined the principles of internal audit team formation (Bou-Raad, 2000). In other words, internal audit functions are exceptional in some case comparing with other functions of organization because of (1) advantageous position of internal audit function within organization, (2) extensive variety of functional areas it examines (including different types of audit), and (3) multidisciplinary backgrounds of individual auditors comprising the internal audit team (Rittenberg & Schwieger, 1997).

Bearing in mind the whole spectrum of functional areas that are examined by the internal audit function, internal audit function is based mostly on two services: assurance services and consulting services. Assurance services are understood 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 for the Professional Practice of Internal Auditing, Glossary).

Consulting services are different from assurance services and are defined as “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 for the Professional Practice of Internal Auditing, Glossary).

According to the Standards for the Professional Practice of Internal Auditing, the nature of work of internal audit function is to evaluate and improve the effectiveness of the risk management processes, control processes and governance processes. *Risk management processes* comprise identification and evaluation of potential risks that might affect the achievement of objectives of an organization and determination of adequate corrective actions. Policies, procedures, and activities, which ensure that risks are kept within the limits defined by management in the risk management process, are defined as *control processes*. *Governance processes* include procedures which allow stakeholders to evaluate risk and control processes defined by management.

According to the Institute of Internal Auditors (IIA), internal auditing reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of assets, the economic and efficient use of resources, and established operational goals and objectives. Internal audits encompass financial activities and operations including systems, production, engineering, marketing, and human resources.

Internal audit relationships

There may be many customers of internal audit services (see *Figure 1*). Customers relatively may be named as internal (CEO’s, audit committee, Board, etc.) or external (external auditors, vendors, suppliers, etc.).

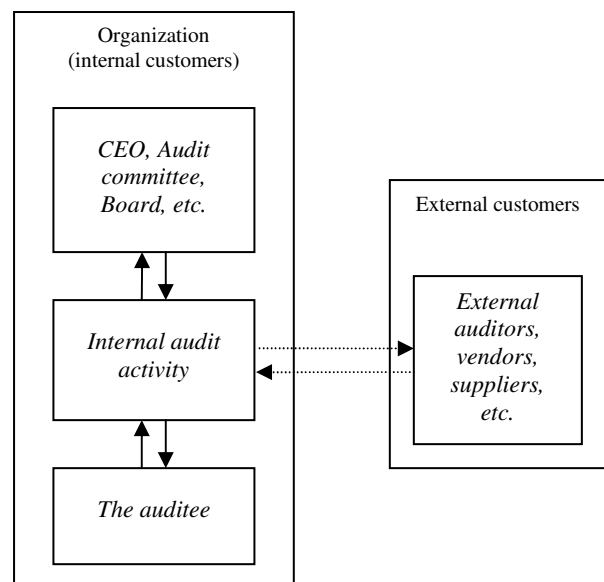


Figure 1. Customers of internal audit services

Detailed relationships with internal customers of internal audit activity are illustrated in *Figure 2*. Dealing with different internal customers may bring potential conflicts.

For example, audit committee may be concerned mostly with risk management and demanding for assurance regarding specific areas (i.e. internal controls). Operating management may express a need for consultations concerning the improvement of operational effectiveness and efficiency. Senior management may be interested in their bonuses and seeking advises from internal auditors how to improve financial results.

As it was mentioned above, the demands from different customers of internal audit services may differ. Operational management is responsible for operational processes and primarily is concerned with effectiveness and efficiency of operations. Thus operational management traditionally is experiencing demand for consultation services from internal auditors. The audit committee is interested in assurance services. Senior management is experiencing the need for both consultations and assurance regarding risks and controls.

Internal audit activity has contributed to an organization's understanding of risk and control in a number of diverse ways (Dittenhofer, 2001; Stern, 1994; Flesher, 1996). For example, internal auditors have performed each of the following functions (Hermanson & Rittenberg, 2003):

- Risk:
 - assess existing risk of audited area and report that assessment to management, the audit committee, or both;
 - develop a plan to systematically assess risk across the organization;

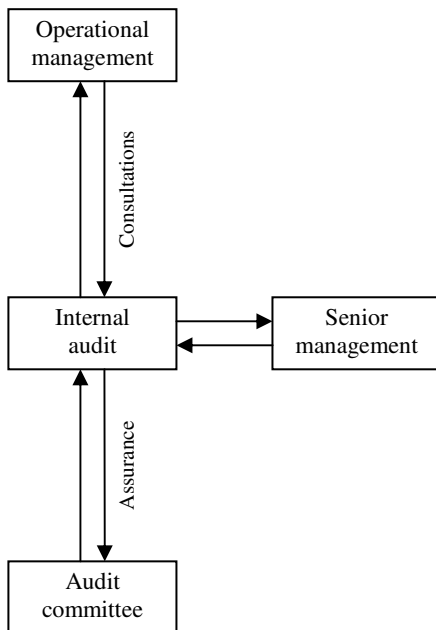


Figure 2. Internal customers of internal audit services (Source: The IIA Research Foundation, 2003)

- lead the risk management activities when a void has occurred within the organization;
- facilitate risk assessment through risk self-assessment techniques;
- evaluate risks associated with new computing developments and stop the project if risks are not controlled at predetermined acceptable levels;

- assist management in implementing a risk model across the organization;
- Control:
 - test compliance with controls in functional areas. Report findings to management, and if important, to the audit committee;
 - assist management in designing a comprehensive assessment, including testing of controls across the organization;
 - assist management in preparing a report on the effectiveness of internal controls;
 - identify significant control deficiencies, including elements of the tone at the top, and communicate to the audit committee (for areas examined);
 - implement computerized testing techniques, e.g., continuous control monitoring techniques, to monitor effectiveness of controls;
 - facilitate the understanding and development of controls within functional areas through control self-assessment (CSA) techniques.

Reporting lines of internal auditors: review of the research results

Independence of auditors was always a sensitive issue. Especially when auditors are not external (truly independent), but internal (Flaherty & Stein, 1991). According to the International Standards for the Professional Practice of Internal Auditing, the Chief Audit Executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.

Practice advisories that generally are the guiding tool for internal auditors and are not mandatory to use state that the Chief Audit Executive (CAE) should be responsible to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations. Ideally, the Chief Audit Executive (a person who is primary responsible for internal audit functions) should report functionally to the board or audit committee and administratively to the chief executive officer of the organization.

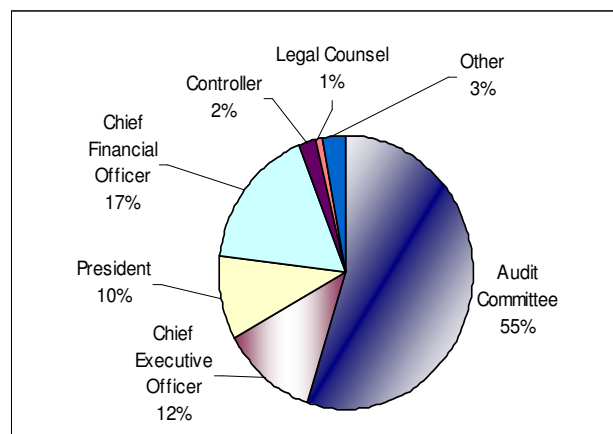


Figure 3. Functional Reporting Responsibilities (Source: The IIA Research Foundation, 2003)

However results of the research show that theoretical approach usually is not always implemented practically. As the survey of the chief audit executives made by the IIA for 2003 shows, functional (direct) reporting lines of the internal audit activity in many cases comply with Practice Advisories (see Figure 3). More than 50 percent of respondents functionally report to the audit committee. However 22 percent of respondents have answered that they report to the president or Chief Executive Officer (CEO).

At the same time near 50 percent of respondents answered that administratively they report to the Chief Financial Officer (see Figure 4). Only 33 percent of respondents administratively report to the CEO or president.

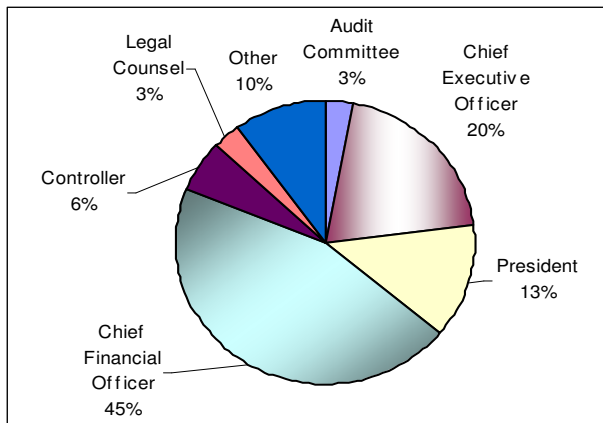


Figure 4. Administrative Reporting Responsibilities
(Source: The IIA Research Foundation, 2003)

A reason why empirical data deviates from theoretical fundamentals may be explained through the concerns of internal auditing in that companies (institutions). That is, in many companies of the respondents internal auditors are more concerned on initial or traditional matters, such as accounting and financial issues, rather on management matters.

Conclusions

Following conclusions may be drawn:

- Initially created as an accounting oriented function internal auditing has been transformed into management oriented profession. Private companies as well as government institutions have become so difficult, large and complex that their managerial line became concerned about monitoring and controlling activities that are in their responsibility. Internal auditors may assist management in many areas.
- Disputes about the internal audit relationships have never turned out since the first appearance of the internal audit. During the emerging phase of internal audit profession the scope of internal auditing and the reporting lines were quite straightforward. However together with expanded functions and changed roles of internal audit a shift of reporting lines has also taken place.
- Although internal audit functions may be used in many areas, internal auditors mainly provide two services to their customers: assurance services and consulting services. Usually the main customers of internal audit services are: operating management,

senior management, audit committee and the board. Needs of these customers regarding internal audit services may substantially differ. Due to the fact that different customers of internal audit services may have different interests, potential conflicts may rise serving these customers.

- According to theoretical fundamentals of internal audit discipline (Standards for the Professional Practice of Internal Auditing, Practice Advisories) ideally the Chief Audit Executive (a person who is primary responsible for internal audit functions) should report functionally to the board or audit committee and administratively to the chief executive officer of the organization.
- However as the latest research of IIA shows, administrative reporting lines in practice generally are not always organized by the theoretical assumptions. A reason why empirical data deviates from theoretical fundamentals may be explained through the traditional concerns of internal auditing, when internal auditors primary concern more on accounting and financial issues rather than on managerial matters.

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Vidaus audito pavaldumo ryšiai: pavaldumo grandinės analizė

Santrauka

Pastaruoju metu vidaus auditas įgauna vis svarbesnį vaidmenį organizacijų valdyme. Sukurtas ir įdiegtas kaip viena iš pagalbinių apskaitos funkcijų organizacijų viduje, ilgainiui vidaus auditas transformavosi į organizacijų vadovybės poreikius tenkinančią discipliną. Pačiame vidaus audito užuomazgos ir vystymosi etape vidaus auditoriai buvo siejami su apskaita bei finansais ir dažniausiai buvo apibūdinami kaip išorės auditorių padėjėjai, o šiuo metu vidaus auditas neabejotinai galėtų būti įvardijamas kaip atskira ir nepriklausoma disciplina, daranti ryškią įtaką organizacijų valdymui. Per pastaruosius penkiasdešimt metų organizacijų veiklos apimtys, sudėtingumas bei tarpusavio santykiai tiek transformavosi, kad jų valdymas tapo itin sudėtingas. Šie pokyčiai vyko tiek privačiose bendrovėse, tiek valstybinėse institucijose.

Pačiuose pradinuose vidaus audito vystymosi etapuose vidaus auditas buvo apibūdinamas kaip „vadovybės ausys ir akys“. Kitaip tariant, vidaus auditoriai turėjo tikrinti, kaip vykdomos ir kontroliuojamos kasdieninės operacijos, ir pateikti vadovybei jų tobulinimo rekomendacijas.

JAV Vidaus auditorių institutas vidaus auditą apibrėžia kaip nepriklausomą, objektyvią tikrinimo ir konsultavimo veiklą, skirtą pridėtinei vertei kurti ir organizacijos veiklai gerinti. Vidaus audito funkcija – sistemingai ir visapusiškai vertinti ir skatinti gerinti organizacijos rizikos valdymo, kontrolės ir priežiūros procesų veiksmingumą ir taip padėti įgyvendinti organizacijai keliamus tikslus. Pateikta vidaus audito definicija akcentuoja, kad iš esmės gali būti keletas vidaus audito paslaugų klientų.

Pagrindinis šio straipsnio tikslas – apibrėžti vidaus audito pavaldumo ryšius atsižvelgiant į plačią vidaus audito funkcijų įvairovę, apžvelgti galimas grėsmes ir konfliktus, galinčius kilti pavaldumo grandinėje, bei išanalizuoti tyrimų rezultatų duomenis teorinių prielaidų kontekste. Tikslas siekiama naudojant mokslinių šaltinių analizę, publikuotų tyrimų apžvalgą bei išvadų formulavimą. Problema nagrinėjama nuo teorinių teiginių pereinant prie praktinių tyrimų.

Vidaus audito funkcija iš esmės skiriasi nuo kitų funkcijų organizacijos viduje dėl savo išskirtinės padėties organizacijoje, didelės apimties funkcinių sričių bei vidaus auditorių kompetencijos daugelyje sričių. Mokslinėse publikacijose (Sawyer, 2003; Hermanson, Ritenberg, 2003; IIA Research Foundation, 2003 ir kt.) išskiriamos šios funkcinės vidaus audito sritys:

- vidaus kontrolės sistemos vertinimas;
- veiklos operacijų auditas;

- procedūrų, politikų ar kt. standartų laikymosi auditas;
- apgavysčių bei neteisėtų veiksmų tyrimas;
- dalinis arba nuodugnus dalyvavimas finansiniuose audituose;
- dalyvavimas rizikos valdymo procese;
- kitos veiklos sritys.

Kita vertus, net įvertinus didelę apimtį funkcinių sričių, kurias apima vidaus auditas, galima teigti, kad iš esmės vidaus auditoriai teikia dvejų rūšių paslaugas: tikrinimo ir konsultavimo. Tikrinimas yra suprantamas kaip objektyvus ir nepriklausomas rizikos valdymo, kontrolės ir vadovavimo procesų įvertinimas. Gali būti tikrinamos įvairios sritys (finansinė atskaitomybė, sistemų saugumas, procedūrų laikymasis ir t.t.). Konsultavimas – tai patarimų teikimas siekiant pagerinti organizacijos veiklą ir sukurti pridėtinę vertę, dėl kurių apimties ir pobūdžio iš anksto susitarta su klientu.

Teikdami savo paslaugas, vidaus auditoriai sąveikauja tiek su savo organizacijos nariais, tiek su kitais išorinės aplinkos dalyviais. Pagal priklausomumą organizacijai vidaus audito klientai sąlygiškai gali būti skirstomi į vidinius ir išorinius. Vidiniais klientais, kaip jau minėta, gali būti vidutinio bei aukščiausio lygio organizacijos (bendrovės, institucijos ir t.t.) vadovybė, vidaus audito komitetas, bendrovės valdyba. Iš išorinių vidaus audito paslaugų klientų būtų galima paminėti išorės auditorius, su kuriais paprastai bendraujama finansinių auditų metu.

Pažymėtina, kad vidiniai organizacijos klientai gali būti suinteresuoti gauti skirtingas vidaus audito paslaugas, kadangi jų veiklos prioritetai yra skirtingi. Dėl šios priežasties vidaus auditoriai dažnai susiduria su potencialių konfliktų grėsme savo pavaldumo grandinėje. Pavyzdžiui, audito komitetų nariai daugiausia akcentuoja ir yra suinteresuoti atskirų sričių (pvz., vidaus kontrolės sistemos) tikrinimo paslaugomis. Tuo tarpu vidutinio lygio vadovybė bus suinteresuota kasdieninių veiklos operacijų efektyvumo bei našumo pagerinimu. Todėl jos poreikis vidaus audito paslaugoms apsiribos daugiausia rekomendacijomis. Kadangi aukščiausio lygio vadovybės atlyginimo ir motyvavimo sistema paprastai yra siejama su finansiniais rezultatais, todėl aukščiausio lygio vadovai paprastai bus suinteresuoti konsultacinėmis vidaus auditorių paslaugomis, nors taip pat jiems turėtų būti aktualios ir tikrinimo paslaugos.

Auditorių nepriklausomumo problema visuomet buvo aktuali. Ypač tuo atveju, jei auditoriai yra ne išorės, bet vidaus. Tarptautiniai vidaus auditorių profesinės praktikos standartai numato, kad vidaus audito vadovas (asmuo, atsakingas už vidaus audito funkcijas organizacijoje) turėtų būti pavaldus bei teikti atskaitas tokiam organizacijos vadovybės lygiui, kuris leistų įvykdyti visus vidaus audito veiklai keliamus reikalavimus.

Praktiniai vidaus audito patarimai, kuriuos parengė ir išleido JAV vidaus auditorių institutas, numato, kad vidaus audito vadovas turėtų būti pavaldus organizacijos vidaus asmeniui, kuris turėtų pakankamai įgaliojimų, leidžiančių užtikrinti didelę vidaus audito funkcijų įvairovę, atitinkamą komunikaciją bei tinkamus veiksmus vidaus auditorių rekomendacijoms įgyvendinti. Idealiu atveju vidaus audito vadovas turėtų būti funkcinio požiūriu pavaldus valdybai, audito komitetui arba kitam organizacijos vadovybės organui, o administraciniu požiūriu – organizacijos vadovui.

Kaip rodo JAV Vidaus auditorių 2003 m. atlikti tyrimai, kurių metu buvo apklausti įvairių organizacijų (bendrovių, įstaigų ir t.t.) vidaus audito vadovai, 55 proc. respondentų funkcinio požiūriu yra pavaldūs audito komitetams (22 proc. – organizacijos vadovui, likę – kitiems organizacijos pareigūnams arba skyriams). Įdomu tai, kad net 45 proc. respondentų administraciniu požiūriu yra pavaldūs organizacijos finansų direktoriams (33 proc. – organizacijos vadovui, likę – kitiems organizacijos pareigūnams arba skyriams). Pažymėtina, kad toks pavaldumas iš esmės susijęs su tradicinių vidaus auditorių funkcijų, svarbių su apskaita bei finansams, akcentavimu.

Raktažodžiai: *vidaus auditas, vidaus audito paslaugos, vidaus audito pavaldumo ryšiai ir pavaldumo grandinė, audito komitetas.*

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