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THE NATURE OF INTERNAL AUDITING

By

Raafat Ali Abdel Moteleb Radwan

*A Thesis Presented for the Degree of
Doctor of Philosophy of
The City University Business School*

The City University, London 1979

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*To my parents and beloved
Egypt*

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PREFACE TO THE RESEARCH TOPIC

This study addresses itself to aspects of *the nature of internal auditing*.

Perhaps we can make this title still more meaningful by focusing on the key terms used.

'The nature of' - that is the essential qualities or the general characteristics of something, here it is an activity.

'Internal' - this term is intended to make clear that this is an activity carried on by an organisation itself using its own personnel. Thus, the activity is distinguished from that which is carried out by external public accountants or outside consultants.

'Auditing' - this term suggests a variety of ideas. On the one hand, it can be viewed very narrowly as the mechanical checking of accounts for clerical accuracy and/or on the other hand as a thoughtful investigation and appraisal at the highest operational levels.

Definitely this term is intended here to embrace the higher level meaning, even though the lower level activities may also be involved to a certain extent.

To recap this boils down to the following:

The general characteristics of an activity carried on by the organisation itself using a group of its own employees to achieve certain objectives through the review of the various means of control used by management in conducting the organisation's activities.

Internal auditing is a relatively new occupation but with roots running well back into the past. This seeming paradox is simply resolved by recognising that internal auditing represents a field of interest which has changed considerably in nature and

scope in a relatively short period of time. A closer look at its development reveals that the first internal auditing assignments usually originated to satisfy very basic and sharply defined needs. The earliest special concern of both the owners and management was essentially to protect the existing situation.

There was also a great emphasis on the detection and prevention of fraud and error; to a large extent internal auditing was viewed as a closely related extension of the work of the external auditor. Internal auditors were then called 'figure checkers', and many people thought of them as spies who "happily they never reproduce and all of them finally go to Hell."⁽¹⁾

The result of these factors was that the internal auditor was viewed as playing a relatively narrow role. He was the financially oriented checker and more of a policeman than a co-worker.

How has internal auditing responded to changing needs? The response can be seen in the successive revisions of the accepted definition of internal auditing as published by the Institute of Internal Auditors, the professional association of internal auditors

"Internal auditing is an independent appraisal activity within an organisation for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls."⁽²⁾

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- 1 Phillips, W.G., "The Internal Auditor and the Changing Needs of Management", The Internal Auditor, Vol.27, No.3 May/June 1970), pp.49-56.
 - 2 The Institute of Internal Auditors, (1947, revised 1957 and 1971) Statement of Responsibilities of the Internal Auditor, (New York: The I.I.A., Inc.).

This statement, itself the revision of the first edition issued in 1947, was again revised in 1971 and the new statement amended the definition by excluding: "accounting, financial and other operations" from the main part of the definition, and substituting the one word "operations" in their place.

The reason for this alteration was that the scope of internal auditing was considered to have progressively changed so that by then it embraced all operations of a business and it was thought advisable to remove the emphasis which both the first and second statements placed on the "accounting and financial matters".

In the light of this it seems that the scope of internal auditing changed giving the profession of internal auditing a great opportunity to extend the service it provides to organisations. The old image of the internal auditor also appears to have changed so that he is now seen to be

"a human person with the charm of a friendly poodle, plus brains, business foresight and a sense of humor. Happily they train others in their image and all of them finally go to Heaven."(3)

In practice, however, there are obstacles in the way of such a roseate future for internal auditing; there are honest differences of opinion on many aspects which relate to the internal auditing activity.

In the social sciences - to which the theory of internal audit belongs - there are invariably problems of how different terms should be used and whether individual terms should be viewed narrowly or broadly. This is specially a problem when the

3 Phillips, W.G., op. cit., p.56.

activities associated with the terms are undergoing major change, and where new terms are being introduced.

Considering internal auditing conceptually, for example, one notes that it has been defined in many different ways. It is part of the whole system of *internal control* in the organisation, but is not an integral part of the *internal check* or the accounting system. Yet, it is generally considered to be a *managerial control* for the objective of appraising all *other controls* which management has formulated.

The consideration of internal auditing from the standpoint of control brings to a head the problem of terminology which exists in the case of the above italicized terms. At one stage, internal check was viewed as having a fairly broad coverage. Later, this particular term had come to have a fairly narrow application to low level types of cross check. Internal control had then become the broader term. But now this term also seems to be acquiring a more limited range and the broader dimensions are described by such terms as "managerial control", "administrative control", "organisational control", or just plain "control" - see (1) and (2) in Appendix (F).

Different people, of course, use all of these terms in different ways. However, a question that needs to be answered is whether internal auditing is part of internal control, or part of managerial control, part of something else. Any suggested answer to this question will determine to a large extent the scope of the internal audit coverage.

Another aspect of this conceptual problem is that internal auditing is usually described as being a staff function which acts as a service to management in the conduct of a business. Over a period of time, this description has been

approved and generally accepted. However, this identification of internal audit with management is now being challenged on the basis that management is not the entire organisation. The owner's interest is a distinct thing from the management interest and it is being suggested that the internal auditor should shift his ground so that he can provide a service to the owners and other interested parties as well as to management themselves. This point of view is demonstrated in the more recent Standards for the Professional Practice of Internal Auditing which provide that:

"Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as *a service to the organisation*. The objective of internal auditing is to *assist members of the organisation* in the effective discharge of their responsibilities." (4) (italics ours)

The new Standards also call for a broader, more comprehensive scope for internal audit so that it can better help the organisation to meet its objectives. It is no longer considered acceptable to restrict internal auditing to merely a detailed *compliance* activity: internal audits should also be made to review the *economy* and *efficiency* with which the organisation's resources are employed and the extent to which planned results are achieved.

4 The Institute of Internal Auditors (1), "Standards for the Professional Practice of Internal Auditing", (Florida, 1978), p.1. see also:
Carolus, R.N. and Barrett, N.J. "The Development of the Standards for the Professional Practice of Internal Auditing", (The Internal Auditor, Vol.34, No.6 December, 1977), p.17.

There are, however, dissenting views on the adoption of this more management-oriented internal audit approach and the question which is often raised is how an individual like the internal auditor, who is not specifically trained in all management specialisms, can be helpful? The internal auditor's dilemma here is paralleled in the context of what are generally called "management-type audits" where there is also a lively debate as to what internal auditing should be doing.

Where does this leave us? - we have a need for further explanations indicating the nature of internal auditing as it should be, and that is the general intention of this study (see: Sec. 2.6).

Organisation of the study

This thesis consists of eight chapters. The first two chapters cover the theoretical background of the research topic. The third chapter addresses itself to the research methodology, and the remaining chapters are devoted to reporting the research findings and conclusions.

The first chapter traces the development of internal auditing from a beginning which was rather menial in nature to its present stature where internal auditors are initiating new types of audit services. This is followed by an elaboration on the current applications for the extended scope of internal auditing with an account of related empirical studies carried out in this area. The last section summarises the main conclusions derived from the discussion in this chapter.

The second chapter is devoted to exploring and evaluating the problems of the extended scope of the internal auditor with reference to its effects on his work. Special emphasis is placed

upon interpreting the internal audit appraisal activity, the susceptibility of various management levels to internal audits, and the nature of internal audit reporting and related reporting problems. This is supplemented by a summary of matters to be empirically explored which includes an identification of the basic objective of the study, the main research areas and hypotheses - see Sec. 2.6.

The empirical framework of the study is introduced in the third chapter in which the scope of the empirical research, the chosen methods of collecting research data, and an appraisal of the actual practical research undertaken, are fully described. Appendices (A) to (E) attached to this study particularly relate to this chapter.

In line with the main research areas - identified in chapter two - come the next five chapters to report on research findings and conclusions. The main conclusions, which are supported by data gathered during this research and were statistically tested, are summarised and presented at the end of each chapter.

Discussion in the fourth chapter is developed to investigate the nature of internal auditing as seen from the standpoint of internal audit's coverage *by management function*. Here, the empirical research is specifically concerned with two main questions:

- (i) does the scope of internal audit actually extend into non-financial aspects of the areas under review, and
- (ii) what are the main factors which have a bearing upon the effective functioning of internal audit in this respect?

These two questions can be said to cover the basic research inquiries which constitute the first main research area of this study.

Looking at the nature of internal audit from another angle, internal audit coverage *by management levels* is investigated in the fifth chapter in which the empirical research is devoted to seek answers to three main questions:

- (i) what levels of the organisation are audited and to what extent does internal audit work at each level?,
- (ii) what is the nature of the internal audits undertaken at each level?, and
- (iii) what are the main factors which have an impact on the effective functioning of internal audit at each level?

These questions can be said to cover the research inquiries which constitute the second main research area of the study.

Chapter six integrates the research findings of the first two areas of the study. Special emphasis is placed upon an interpretation of the internal audit appraisal activity as perceived by both auditors and auditees in addition to an analysis of the associated problems which internal auditors face.

The seventh chapter is then devoted to an investigation of the general features of internal audit activities in terms of *protective* and *constructive* audit services. This is done through an in-depth analysis of internal audit 'points' (i.e. audit findings and recommendations) made in audit reports to management in the organisations participating in the study.

Special attention is paid to (i) an analysis of internal audit effort with respect to historical versus pre-event audits,* and (ii) the nature of internal audit reporting.

In the eighth and final chapter, the significant findings from the preceding chapters are related to one another to form an integrated picture of research conclusions, thus setting the stage for suggestions for further research.

The study is supplemented by appendices which, in particular, relate to chapters two and three.

Appendix (A) includes copies of research correspondence.

Appendix (B) contains a copy of the Internal Audit Managers' Questionnaire.

Appendix (C) contains a copy of Questionnaire for Executive Managers.

Appendix (D) contains a copy of the Interview Schedule and a copy of Questionnaire for the Investigation of Internal Audit Reports.

Appendix (E) provides additional clarifications to illustrate the way in which research areas and related hypotheses were organised and developed in connection with relevant sources of empirical research evidence.

Appendix (F) includes a critical discussion of certain aspects of control theory particularly relating to the main research areas of this study. The discussion is developed with

* An example of a pre-event audit would be the audit of a computer system while it was being designed; an historical audit of the system would be when the auditor reviewed it sometime after it had been implemented - see: Sec. 2.3.3.

special emphasis on aspects of the management process which pertain to the control function and their effect on the work of the internal auditor. This is followed by a brief summary of each technical term used in the study.

Finally, concise references to all works referred to in the study are provided in a bibliography.

CHAPTER 1

DEVELOPMENT OF INTERNAL AUDITING

An understanding of the nature of internal auditing requires an appreciation of its historical development.

A review of the history of internal auditing not only provides a basis for analysing and interpreting the changes which have taken place in its nature but it may also reveal prospective extensions in audit scope and help to determine direction and appropriateness of change.

The discussion in this chapter will be concerned with the following main subject matters:

1. The principal factor which influenced the emergence of the internal audit activity.
2. Early internal audit objectives and scope.
3. World War II - the turning point.
4. A new constructive image for internal auditing.
5. Current concepts of internal auditing.
6. Conclusions.

1.1 The principal factors which influenced the emergence of the internal audit activity

It is safe to say that internal auditing has been undertaken for as long as there have been businesses, but not until the late 19th century was there a specific occupation of internal auditing in business organisations.⁽¹⁾

Internal auditing as a separate job classification occurred in a few industries (e.g. the railroad industry) by the 19th century.⁽²⁾

It is normal for any activity, including a control activity such as internal auditing, to come into being as a result of emerging needs. Internal auditing as a separate function within the enterprise developed gradually in response to the needs of both the owners and management in the conduct of a business.

Corporate enterprises increased rapidly in the 19th and 20th centuries and one of the most important influences upon the development of external and internal auditing was the separation of the management function from ownership. The 1844 U.K. Joint Stock Companies Act stipulated that directors provide annually to the shareholders a balance sheet, and provided for the appointment of auditors (who were not, however, required to be independent of management).

1 National Industrial Conference Board, "Internal Auditing", Studies in Business Policy No.3 (New York: N.I.C.B., 1963), p.4.

2 Stettler, H.F. (1), "Auditing Principles", (N.J.: Prentice-Hall Inc., 1970), p.66.

On the one hand, as management passed from individual owners to hired professionals, the owners in absentia became concerned over the proper protection and growth of their capital investment. Thus, it became usual for shareholders to appoint professional auditors to act on their behalf, in order to examine the books and accounts of the company, and report to them on every balance sheet and profit and loss account laid before the company in the general meeting. In addition, the audit acts as a check upon the directors, and as a precaution against fraud on the part of the employees.

On the other hand, due to the great increases in the quantity of capital concentrated in large corporations, the need for a separate protective function developed from (a) the owners' need for additional protection of their investments, and (b) the professional directors' need for protection with respect to their responsibility for safeguarding the resources of their corporations.

The use of resident auditors was one way in which additional assurance could be offered to both shareholders and professional directors as to the protection of resources of the enterprise.

With the rapid growth of business, the increase in size of many enterprises, the extended span of control faced by management in concerns employing thousands of people and conducting operations from widespread locations, the practice of external auditing in larger concerns, there developed the necessity for tightening up of controls

over all aspects of the business of the company in an orderly manner in order to safeguard its assets and secure as far as possible the accuracy and reliability of its records.

These came gradually into view under what were known then as 'internal checks and controls'. It is worth pointing out that as far back as 1494 the Italian philosopher, Fra Luca Pucioli, wrote a treatise in which he described the double entry bookkeeping system, referred to the importance of internal controls, and recommended that the books be audited for internal check.⁽³⁾ In fact, the impetus for such developments ultimately came largely from management and external auditors.⁽⁴⁾

Management had recognised internal checks and controls valuable tools in effectively discharging their responsibilities; and external auditors had pressed for improvement in internal checks and control in their efforts to be of assistance to their clients, as well as to permit reductions in audit work made possible by the concomitant increase in the credibility of the accounting records.

The growing recognition by management and external auditors of the benefits of good internal checks and

3 Anderson, R.J., "The External Audit: Concepts and Techniques", (Toronto: Pitman, 1977), p.7.

4 Stettler, H.F. (1), op. cit., p.41.

controls and the complexities of an adequate system of internal check in a large business have underpinned the development of internal auditing leading to its appearance in many organisations.

Management had noted that an efficient internal audit department not only could be used as a tool to measure and evaluate the effectiveness of other types of control, but could also contain the cost of the external audit. In some organisations the internal audit department was created especially to take advantage of the possible reduction in the amount of the external auditor's fee, viz:

"A few corporations openly admitted that one objective in establishing internal audit departments was to reduce the scope and cost of audits by independent public accountants. To carry out this objective the internal auditors were instructed to work as assistants to the public accountants during the annual audit, preparing schedules and doing other routine tasks which might otherwise have been assigned to junior members of the public accountant's staff."(5)

On the other hand,

"Public accountants have played a material part in fostering a recognition of the importance of internal auditing and have in fact, in some instances, recommended that an internal audit department should be established in order to ensure that systems of internal check are sound and that financial statement are accurate."(6)

It is within this context that public accountants have relied on internal auditors and co-operated with them. Perhaps this early association explains why most internal

5 Meigs, W.B., "The Expanding Field of Internal Auditing", (The Accounting Review, XXVI October, 1951), p.520.

6 Bigg, W.W. and Davies, J.O., "Internal Auditing", (London: H.F.L. 'Publishers' Ltd., 1959), p.153.

auditors have been recruited from the accounting profession in general.

1.2 Early internal audit objectives and scope

In what might be called the formative days of internal auditing, the chief objective of an audit was mainly protective in nature and the work of the internal auditor tended to be rather routine.

The type of work done by the internal audit staff consisted of the checking of accounting records, verification of mathematical computations⁽⁷⁾, the testing of transactions, and ascertaining that the organisation was not being defrauded.⁽⁸⁾

Internal auditing was primarily fraud-preventive and error-preventive. Fairly typical of the acceptance of this description as to the main objective of internal auditing is the following:

"Protection of company assets and detection of fraud were the principal objectives. Consequently, the auditors concentrated most of their attention on examinations of financial records and on the verification of assets that were most easily misappropriated. A popular idea among management people a generation ago was that the main purpose of an auditing programme was to serve as a psychological deterrent against wrongdoing by other employees."⁽⁹⁾

This is not surprising since the internal auditing service functioned to protect the investments of the

7 Shaw, M.K., "Internal Auditing Our Promotable Product", (The Internal Auditor, Vol.19, Spring 1962), p.10.

8 Taylor, P.J., "Appraising a Corporate Organisation", (The Internal Auditor, Vol.19, Winter, 1962), p.28).

9 National Industrial Conference Board, op. cit., p.2.

organisation thus satisfying needs of both owners and management alike.

Hence, internal auditing was primarily considered as a separate protective function and used essentially as an extended application of the principle of direct control. The protective feature of the internal audit function is highly significant, and "the auditor's traditional role in connection with safeguarding assets continues to be important".⁽¹⁰⁾

In addition, internal audit's antecedents were related to financial auditing. As a result, its principal objectives were closely linked to the parallel objectives of financial audits performed by the public accountants and which were at this time: 'detection and prevention of fraud and errors'.⁽¹¹⁾ Therefore, the scope of the internal auditor's activity was confined merely to the accounting matters and directly related to the system of internal check.

Considering the importance placed on fraud detection in the history of auditing, it was not surprising that much of the general public and many of the employees within organisations viewed the auditors as detectives or policemen.⁽¹²⁾ This inherited image is one that internal audit in particular has suffered from, having an impact

10 Chambers, A.D. (1), "The Structure of Internal Auditing", (Accountancy, Vol.85, No.974, October, 1974), p.41.

11 Brasseaux, J.H. and Edwards, J.D., "Readings in Auditing", (Ohio: South-Western Publishing Co., 1973), p.7.

12 Ibid., pp.5-7.

on internal auditor-auditee relationships at least until recently (see: 5.3.4.3 et seq).

Fairly typical of the acceptance of this impression of the auditor are the following quotations:

"It was our job, as public accountants, to evaluate the fairness of the financial reporting of the company. Meanwhile, the internal auditors continually performed a check of transactions within the companies. Both outside and internal auditors in those days had pretty lousy reputations. We were called 'figure checkers', and many people thought of us as spies."(13).

"This was particularly true of the internal auditor. He was an infiltrator for management who often arrived unannounced. He completed his audit in an abrupt manner and left without any evaluation or even a wrap-up session."(14)

1.3 World War II - the turning point

We have seen that in its formative days, internal auditing was almost entirely protective in nature, and the work of internal auditors consisted largely of routine examination of details. Meigs, writing of the North American scene, said:

"During World Warr II .. corporate management was faced with the problem of expanding the scope of operations beyond all previously conceived boundaries. In this period of unlimited demand for production, corporate management was handicapped by inadequate plant facilities and widespread use of inexperienced personnel. The possibilities for gross inefficiency, for costly blunders and for gigantic fraud convinced management of the urgent need for adequate systems of internal control. The internal auditor acquired widespread recognition as the expert specialising in the design and maintenance of internal controls."(15)

13 Phillips, W.G., Loc. cit.

14 Idem.

15 Meigs, W.B., op. cit., pp.519-520.

During World War II, and as it came toward an end, the internal auditor proved able to do an effective job, and as a result not only was upgraded in the minds of management but cemented good relations with the public accountants as well.⁽¹⁶⁾ It is no coincidence that The Institute of Internal Auditors, currently with in excess of 18,000 members worldwide, was established in 1941 in New York.

Business managements then became concerned with what the postwar period would bring. There was a very competitive market situation in which many firms in certain markets had surplus capacity to be used, and the market for products was very much unsaturated. In order to regain profitable non-war-economy operations, managements were concerned to devise ways of producing revenue coupled with cost reduction. This at a time when the greatly increased size and complexity of large numbers of enterprises, as well as geographical dispersion of their business operations, had prevented managements at higher levels from maintaining close contact with day-to-day events of their enterprises. In attempting to cope with these general problems, managements noted that more communication and coordination within corporations was necessary.

At this point, managements began to examine the role of internal audit to determine whether it could assist

16 Shaw, M.K., op. cit., pp.10-11.

with the problems of controlling organisations which were difficult to control. This led to an enhanced role for internal audit, viz:

"The concept of internal auditing ... to an increasing degree ... is viewed as an arm of management. This development is a product of the modern business environment. The larger and more complex the business organisation, the greater is the gap between administrative or executive and the individual operator. Consequently, a sort of liaison is necessary ... reviews are necessary to keep the business machine functioning smoothly."(17)

During this development phase, internal auditors were generally familiar with the companies they served and their problems; they were also already schooled in the principles of internal check systems. Nevertheless, certain difficulties were encountered in management's attempt to make internal audit fully effective as an aid to the achievement of control over all an organisation's aspects.

In general, four main obstacles were found to be hampering the internal auditor from being of maximum usefulness to management. It was considered that he generally did not have enough authority to conduct investigations into all areas of the organisation. A second limitation was that the rather low calibre of many of the internal audit staff. Thirdly, the reporting level of the internal auditor was too low.⁽¹⁸⁾ A fourth crucial

17 Heckert, J.B., and Willson, J.D., "Controllership", (New York: The Ronald Press Company, 1963), p.671.

18 Meyers, E.B., "Operational Auditing", (The Internal Auditor, Winter, 1966), pp.17-24.

obstacle is the problem of role conflict.

The first of these four obstacles has proved to be quite stifling and prevented management from obtaining the desired benefit from the work of the internal auditor. In this context, one of the basic principles upon which internal auditing should be founded is its freedom to investigate any phase of an organisation's activities at its own discretion and under any circumstances or at any time.⁽¹⁹⁾ Unless a reasonable amount of freedom is allowed to the internal auditor, he will find that his field is considerably restricted by functional boundaries. In practice, if an investigation led to a department over which the internal auditor's right of access did not extend, the auditor would then have to let the matter drop. Yet, when the internal auditor's investigative authority was extended to allow access to most or all areas within the organisation, much useful information was generated by the auditor which hitherto had not been available. The audit of the process by which new products are launched is an example of an audit which would cut across several functional boundaries and could only be carried out if the auditor had the authority to work in each of the functional areas involved.

As to the second limitation, the modest calibre of many internal audit staff had resulted from much of the auditor's work having been a routine examination of details and a searching for clerical errors. For this

19 Bigg, W.W. and Davies, J.O., op.cit., p.7.

type of work, generally the essence of internal auditing prior to World War II, only a minimal mastery of theoretical concepts and little by way of an enquiring mind was required. As a result, many internal auditors were not fitted for an extended auditing role. Because of this, individuals with the education and training required had to be convinced that there was a new role for internal auditors which would provide challenge, opportunity and interest. Management themselves were often inclined to have negative views about an expanded role for internal audit as they understandably tended to interpret the potential of the internal audit activity in terms of the modest capabilities of the internal auditors in post.

It has been said that ...

"unless ... a narrow scope of 'audit' work is avoided, the right calibre of man will not wish to become an internal auditor and the general standing of internal auditors will not be improved. Whether it really would help to find an alternative description to that of 'internal auditor' is best left for another day, but perhaps the heart of the problem, which is common to internal auditors, is not in necessarily changing the name but in making the audit function attractive to the young man."(20)

20 (n.n), "New Outlook on Internal Auditing", a series of articles taken from The Accountant Magazine, 1973.

Even recent studies have emphasised that the calibre of the internal audit staff is still an issue:

"The length of stay of employees in internal auditing and their destinations upon leaving were examined. This research finds the average length of stay of an internal auditor to be short. This 'short stay' characteristic is likely to contribute to the job dissatisfaction of many internal auditors."(21)

The third of these limitations centred upon the reporting level of the internal auditor. When the early use of the internal audit function was protective in nature, and the work of the internal auditor tended to be rather routine, there was no need for him to report to an officer at higher management levels, unless there was a serious case of fraud or dishonesty.

However, as soon as the internal auditor's work expanded in scope, it became desirable that the internal auditor should be made responsible to some upper management levels.

Four main reasons were behind this desirable change. First, if the auditor were responsible to someone at higher management levels, he would be more likely to be received as a person of higher status within the organisation rather than as a rather insignificant "figure checker". In this new capacity he would command the respect of the managers concerned with the areas under review and thus be able to function more effectively. Secondly, if the auditor

21 Chambers, A.D. (2), "The Staffing Profile of Internal Auditing and the Role of the Graduate", Proceedings of the Second Annual Conference on Recent Developments in Internal Auditing (London: The City University Business School, May 24th 1977), p.61.

reported to someone at the lower or middle managerial level, information useful to top managerial levels might never reach them. Thus most internal audit reports would fail to pass along available information to satisfy higher management needs. Thirdly, if the internal auditor reported to a line manager within a particular function (e.g. the Chief Accountant) then he would not be able to effectively review in an independent manner the tasks of that function which would be, after all, governed by the responsibility and wishes of the line manager to whom the auditor reported. Fourthly, there is a possibility that the auditor would not be welcome outside the particular area within which he reported, and this of course would have a great impact on the ability of the auditor to extend the scope of his audit beyond this functional area.

The fourth obstacle which management had to face in making the audit function fully effective has to do with the problem of role conflict. In the earlier days of internal auditing the concern of management with the detection of fraud was a major motivation for the creation and expansion of internal audit departments. In most cases, however, this created an image of the internal auditor as being an inspector.

This view by the auditee of the auditor's role has proved to be incompatible with the internal auditor's desire to fulfil an advisory auditing role. Understanding this situation is important because it is an image which to some extent still follows, which inhibits the

internal auditor and which may prevent him from being of maximum usefulness to the organisation he serves even if the character of the internal audit function and the auditor's emphasis are both constructive rather than inspectoral. The inspectoral image persists. (22)

Conflict in internal auditing is not just a conflict between the image the auditor has of himself ('constructive advisor') and the image the auditee tends to have of the auditor ('policeman' or 'inspector'). It is possible there is a fundamental conflict within the internal auditor himself in that he is trying to be both 'policeman' and 'advisor' at the same time and that these two roles are incompatible. Whereas a policeman has formal authority derived from his office and supported by sanctions to coerce others into compliance, an advisor has only informal authority derived from his reputation and from the quality of his advice; an advisor can try to persuade but he does not coerce. The auditor shows signs of trying to fulfil both roles, the advisory role being associated with the developing scope of internal audit. There is a danger that he will fall between two stools. (23)

Some ideas and solutions have been experimented with to overcome these troublesome limitations faced by management in making the audit function fully effective in its

22 Chambers, A.D. (3), "The Internal Audit of Research and Development", (R & D Management, Vol.8, No.2, February 1978), p.95.

23 Morgan, G. and Battinson, B., "The Role and Objectives of an Internal Audit - A Behavioural Approach", (The Chartered Institute of Public Finance and Accountancy, January 1975).

expanded role. It was not until the late forties that the matter received serious consideration, and this introduces us to a period of dramatic and rapid changes in internal auditing.

1.4 A new constructive image for internal auditing

The route along which 'modern' internal auditing was to develop had been largely mapped out in the decade immediately following the second world war following the formation of the Institute of Internal Auditors (I.I.A.) in 1941.⁽²⁴⁾ An indication of the extent to which internal auditing had developed in practice as well as in conception may be found in the text of a speech given by the first president of the I.I.A. in 1941 at its formation. He listed what were believed in his opinion to be the major functions of the internal auditor. Those functions were given as:

"(i) he 'the auditor' acts as an arm of management; (ii) he rounds out and perfects the system of internal control; and (iii) he directly participates in verification of financial statements."⁽²⁵⁾

It is interesting to note that he also identified the first function listed (i.e. as an "arm of management"), as having the greatest potential for internal audit's future growth.

24 Chambers, A.D. (4), "Internal Auditing as a University Pursuit", Proceedings of the First Annual Conference on Recent Developments in Internal Auditing, (London: The Graduate Business Centre of The City University, 24-25 Feb. 1976), p.99.

25 Thurston, J.B., "1941 - Modern Internal Auditing Has Just Been Born", speech of first president of The Institute of Internal Auditors at the inaugural meeting. Reprinted in The Internal Auditor, Summer 1966), p.59.

This highlights that the time was then ripe for a new constructive auditing image to emerge; as contrasted with the emphasis given to the protective function which had been recognised as the internal auditor's sole objective.

An interpretation of 'constructive' internal auditing was made by the first vice-president of the I.I.A., who was also the Chairman of the Research Committee of the I.I.A. responsible for the formulation of the first Statement of the Responsibilities of the Internal Auditor,* as follows:

"The constructive objective deals primarily with the challenge and evaluation of existing company practice, and includes suggestion, and recommendation, directly or indirectly as to changes which might be made to achieve better practice and greater company welfare."(26)

Evidence of this shift of emphasis beyond the protective style of internal auditing can be best summed up by comparing the original wording of the Statement of the Responsibilities of the Internal Auditor (hereafter referred to as the S.R.I.A.) which was first professed by the I.I.A. in 1947, with the revised version of the S.R.I.A. issued in 1957.

* See the 'Preface' of this thesis, p.xi

26 Brink, V.Z. (1), "Some Background on the Institute's Statement of the Responsibilities of the Internal Auditor", (The Internal Auditor, Fall 1966), p.67.

The nature of internal auditing in the S.R.I.A.'s 1957 reads as follows:

"Internal auditing is an independent appraisal activity within an organisation for the review of accounting, financial and other operations as a basis for service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls."(27)

In the 1957 S.R.I.A., the last sentence of the 1947 version had been omitted. This read:

"It (internal auditing) deals primarily with accounting and financial matters, but it may be also deal properly with matters of an operating nature."(28)

Further changes in the same direction were made in the 1971 S.R.I.A. revision where all specific mention of accounting and financial review had been omitted, as seen in the following statement:

"Internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls."(29)

This constructive, extended role of the internal audit function suggests that it is appropriate for the internal auditor to go beyond financial areas into any phase of business activities where he can be of service

27 The I.I.A. (2), "Statement of Responsibilities of the Internal Auditor", (New York: The I.I.A., Inc., 1957).

28 The I.I.A. (3), "Statement of Responsibilities of the Internal Auditor", (New York: The I.I.A., Inc., 1947).

29 The I.I.A. (4), "Statement of Responsibilities of the Internal Auditor", (New York: The I.I.A., Inc., 1971).

to management. This broad view is held by the I.I.A. as clearly shown in the following statement concerning the objective and scope of internal auditing:

"The objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor is concerned with any phase of business activity where he can be of service to management. This involves going beyond the accounting and financial records to obtain a full understanding of the operations under review.

The attainment of this overall objective involves such activities as:

- Reviewing and appraising the soundness, adequacy, and application of accounting, financial, and other operating controls, and promoting effective control at reasonable cost.
- Ascertaining the extent of compliance with established policies, plans, and procedures.
- Ascertaining the extent to which company assets are accounted for and safeguarded from losses of all kinds.
- Ascertaining the reliability of management data developed within the organisation.
- Appraising the quality of performance in carrying out assigned responsibilities.
- Recommending operating improvement."(30)

Within these boundaries, it is interesting to note that the only limitation on the scope of internal auditing is that its service to management must be the overall objective of an audit.

With the issue of the Standards for the Professional Practice of Internal Auditing in 1978, however, it seems that a new leaf in the history of internal auditing was opened. The Standards described the nature of internal auditing as follows:

"Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation."(31)

It is noteworthy that in the Exposure Draft of the Standards, it has been suggested that internal audit might

"be concerned with any activity of the organisation. Consequently, the practice of professional internal auditing goes beyond examining accounting controls, records, and financial statements and reports."(32)

It is interesting to note that the latter quotation was dropped from the final Standards probably because it was found to be contentious. The final Standards represent a considerable watering down of the Exposure Draft of the Standards with respect to the extended scope of internal auditing. Clearly opposition was encountered to some aspects of the expanded role of internal auditing as set out in the Exposure Draft.

The final Standards proceed to describe the scope of internal auditing as follows:

31 The I.I.A. (1), op. cit., p.1.

32 Carolus, R.N. and Barrett, N.J., op. cit., p.17.

"THE SCOPE OF THE INTERNAL AUDIT SHOULD ENCOMPASS THE EXAMINATION AND EVALUATION OF THE ADEQUACY AND EFFECTIVENESS OF THE ORGANISATION'S SYSTEM OF INTERNAL CONTROL AND THE QUALITY OF PERFORMANCE IN CARRYING OUT ASSIGNED RESPONSIBILITIES. ...

... ..

The purpose of the review for adequacy of the system of internal control is to ascertain whether the system established provides reasonable assurance that the organisation's objectives and goals will be met efficiently and economically.

The purpose of the review for effectiveness of the system of internal control is to ascertain whether the system is functioning as intended.

The purpose of the review for the quality of performance is to ascertain whether the organisation's objectives and goals have been achieved.

The primary objectives of internal control are to ensure:

1. The reliability and integrity of information
2. Compliance with policies, plans, procedures, laws, and regulations
3. The safeguarding of assets
4. The economical and efficient use of resources
5. The accomplishment of established objectives and goals for operations or programs."(33)

The new Standards take the internal audit function into new horizons in which the internal auditors render their service to the organisation as a whole and not merely management, as defined in the I.I.A.'s Statement, 1971.

This evolving concept of internal auditing clearly indicates that it is becoming, and may continue to become, more accountable to others - such as to the Audit Committees of Board of Directors and to society, in

33 The I.I.A. (1), op. cit., p.300-1

general rather than exclusively to management.

It can be recognised also that the scope of audit work stated in the new Standards is broad and comprehensive, ranging from auditing financial areas, a traditional concern of internal auditing, to determining the degree to which the organisation's objectives and goals are achieved.

"What is being implied here is a two-dimensional evolution of internal auditing. Firstly, internal auditing is seen as evolving from an audit of compliance with internal and external procedures and regulations to one which is also concerned to appraise efficiency and effectiveness. Secondly, internal auditing is seen as evolving to embrace the audit (whether compliance, efficiency or effectiveness auditing) of all operations and not merely accounting and financial matters."(34)

1.5 Current concepts of internal auditing

The foregoing discussion shows that internal auditors perceived opportunities which existed and realised that they could be served in a variety of ways. One major evidence of this interest was internal audit's move to extend its activities to embrace the so-called "management-type audits", - so successfully that a wide

34 Chambers, A.D. (5), "The Changing Role of Internal Auditors", (Accountancy, Vol.89, No.1024, December 1978), pp.56-57.

sector of internal auditors look upon internal and management-type auditing as being virtually the same. (35)

In fact the term "management-type auditing" is used in several different ways by persons of varying professional interests. In addition to the internal auditor's interest in this area, management consultants have referred to management audits in the context of organisational evaluation for the purpose of defining and explaining problem areas. This usage is similar to that employed by some CPA's with reference to management services engagements. Other CPA's have used the term 'management auditing' in the context of independent attestation of management for the benefit of third parties.

The following discussion is mainly concerned with the study of management-type auditing as viewed and interpreted by internal auditors.

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- 35 See for instance: The I.I.A. (5), "An Evaluation of Selected Current Internal Auditing Terms", (Florida: The I.I.A. Inc., 1975). See also:
- a - Bishop, D. "Management and Operation Auditing", (The Accountant, August 29, 1974), pp.262-263.
 - b - Smith, C.H. et al, "The Need for and Scope of the Audit of Management", (Accounting Review, April, 1972), pp.270-283.
 - c - Carmichael, D.R., "Some Hard Questions on Management Audits", (Journal of Accountancy, February, 1970), pp.72-74.
 - d - Secoy, T.G., "A CPA's Opinion on Management Performance", (Journal of Accountancy, July, 1971), pp.58-59.
 - e - Leonard, W.P., "The Management Audit: An Appraisal of Management Methods and Performance", (N.J.: Prentice-Hall Inc., 1967).
 - f - Buckley, J.W., "Management Services and Management Audits by Professional Accountants", (California Management Review, Vol.9, No.1, Fall 1966), pp.43-50.

1.5.1 Internal auditor's interpretation of 'management audits'

Internal auditors appear quite definite in their view that "management-type audits" are not for the purpose of evaluating the quality of management themselves but rather of evaluating the efficiency of management systems that enable an organisation to be managed and to function.

For example, in expanding the scope of the internal audit in the context of management audit, Francia and Neyhart have said:

"....., the concept of the management audit deals essentially with the procedural element of internal control, expressed in terms of competence in planning and directing operations. Since the internal auditor is charged with ensuring the continued effectiveness of the internal control system, the appraisal of management character must enter into the sphere of his responsibility in the total management audit."(36)

There seems to be rather general agreement among internal auditors that such a behavioural appraisal of management including a character evaluation is not a good entree for expanding the internal auditor's activity.

For instance, A.D. Chambers pointed out that:

"Most internal auditors in the UK try to avoid the term 'management audit'. If it means auditing management's systems (at any level) we are happy with the term, but prefer to call this simply 'internal auditing'. The objective of internal auditing is not to audit the quality of management (individuals) itself, but rather to audit the quality of management systems."(37)

36 Francia, A.J. and Neyhart, C.A., "Byond the Management Audit", (The Internal Auditor, Vol.28, No.3, May/June 1971), pp.32-36.

37 Chambers, A.D. (6), "Personal Interview", (Sep. 1974).

This view was also indicated quite explicitly by C.R. Gollihar when he said:

"I consider a management audit to be an appraisal of the management systems that are in operation, not of the individuals doing the managing."(38)

Different words but in line with the same thought were introduced by Koontz & O'Donnell:

"Another direction in which the principle of direct control has led, is in the developing interest in management evaluation; this does not aim at evaluating managers as individuals but rather at looking at entire systems of managing an enterprise."(39)

If a management audit is limited to reviewing the quality of internal control, it is natural for the quality of management to be included within with purview as management themselves are essential components of internal control. While it is reasonable for internal auditors to claim that the adequacy of internal control (rather than of management) is the main purpose of the audit, it is inconsistent to fail to review management as part of the audit. Nevertheless this is what internal audit try to do. The key to this anomaly is to be found in the role conflict issue: auditors need acceptance as advisors, not rejection as inspectors. If audit work is seen as a

38 Gollihar, C.R., "What Management Expects from a Management Audit", (The Internal Auditor, Vol.29, No.3 May/June, 1972), p.33.

39 Koontz, H. and O'Donnell, "Principles of Management - An Analysis of Management Functions", (New York:McGraw-Hill Book Company Inc., 1972), p.662.

threat to individual managers there is no chance of the auditor's image as a policeman being eradicated. Consequently auditors try hard to avoid personal references as a matter of expediency rather than of principle.

... Perhaps the uncertainty as to whether or not management-type audits are essentially the review of managers, explains why the term 'operational auditing' has received majority support in the literature to address the broadened scope of internal auditing. The term 'management auditing' appears more popular with the CPA's and MC's. In management audit, the auditor apparently would evaluate the personnel as well as the plans and elements of control. In operational auditing, the auditor would appraise the systems of control only.

This view was emphasised by R.E. Seiler when he stated:

"Operational auditing is nothing more than a review of controls. ... the only thing new about operational auditing is that non-financial controls are being reviewed."(40)

In more specific terms, C. Heyel described these 'non-financial controls' as follows"

"The operational controls which are reviewed and analysed by the internal auditor include:
(1) organisation structure, (2) procedures,
(3) accounting and other records, (4) reports,
and (5) standards of performance (such as budgets and standard costs)."(41)

40 Seiler, R.E., "Operational Auditing and Motivative Executive Action", (The Internal Auditor, Vol.19, No.3, Fall 1962), p.55.

41 Heyel, C. (1), "Encyclopedia of Management", (New York: Reinbold Book Company, 1963), p.369.

An indication of the internal auditor's main purpose in auditing such controls was given by A.O. Hinkle when he pointed out that:

"The primary objective of operational audits is to appraise the adequacy and effectiveness of the components of the overall system of internal control. ... In operational audits, deliberate tests must be made to determine, first, whether adequate controls have been established, and second, whether controls are actually functioning as intended." (42)

H.F. Stettler has additionally touched upon the significance of operating efficiency and improvement in conducting operational audits when he said:

"A natural outgrowth of the functional approach to internal auditing has been to expand the internal auditing horizon beyond the traditional accounting and financial activities. ... The term 'operational auditing' appropriately has been adopted to describe such expansion. The operational audit concentrates on seeking out aspects of operations in which waste, inefficiency, and excessive costs would be subject to reduction by the introduction or improvement of operating controls."(43)

J.T. Choi has introduced an interpretation of the term 'operational auditing' which summarises most of the main points of the previous explanations, and also reveals the importance of efficiency and effectiveness as key objectives in an operational audit:

42 Hinkle, A.O., "Increasing the Auditor's Responsibilities", (The Internal Auditor, Vol.19, No.1, Spring 1962), p.27

43 Stettler, H.F. (2), "Systems Based Independent Audits", (N.J.: Prentice-Hall, Inc., 1967), p.70.

"Operational auditing is a comparatively new control technique which provides the internal auditor with a method for evaluating the effectiveness of operating procedures and internal controls. It is a constructive method of assisting management to improve the operations of its business. The auditor's work in operations should be directed to the evaluation of the adequacy and effectiveness of management controls to the end of achieving management's objectives, rather than to the direct evaluation of the degree of technical ability or judgement in performing the operational functions."(44)

However, internal auditors represented by the I.I.A. have given the term 'operational auditing' a broader meaning and more wide coverage. This is indicated clearly in their recommended definition for operational auditing as follows:

"An operational audit is a future-oriented, independent, and systematic evaluation performed by the internal auditor for management of the organisational activities controlled by top-, middle-, and lower-level management for the purposes of improving organisational profitability and increasing the attainment of the other organisational objectives: achievement of program purposes, social objectives, employee development. Areas in which efficiency and effectiveness may be improved are identified, and recommendations are made that are designed to enable realisation of the improvements. The measure of effectiveness includes both an evaluation of compliance with prescribed entity operational policies and of the adequacy of the policies. Financial data may be a source of evidence, but the primary source is the operational policies as related to the organisational objectives. Included are an evaluation of the management control system in terms of existence, compliance, adequacy, and the management decision-making process in terms of existence, compliance, and relevance to the attainment of organisational objectives."(45)

44 Choi, J.T., "Operational Auditing: Part 1", (The Internal Auditor, Vol.28, No.2, March/April 1971), p.18.

45 The I.I.A. (5), op.cit., p.51.

It can be recognised that the full scope of an internal audit as described in the new Standards published by the I.I.A. is largely a direct, more specific translation of this broad definition of auditing.

This is indeed a broad undertaking which reflects a great progress in the scope of audit coverage of operational activities. In fact, the internal auditing profession through its own self development and dedication has contributed to this progress and has set the stage for continuing progress. How then do internal auditors approach this type of audit? Some authorities believe that financial and operational audits should not be distinguished separately.⁽⁴⁶⁾ In their opinion, the same techniques employed for financial audits also apply to internal audits of any other description. Thus, operational auditing could be performed as an extension of a financial audit. However, since the emphasis on operational controls distinguishes operational auditing from other aspects of internal auditing, the auditor in operational auditing is furthest from the point of performing a financial verification of accounts and is immersed in the current functions of the operation or department.

Therefore, some other people believe in approaching operational auditing as a planned review of specific operations rather than approaching them necessarily as a

46 Cadmus, B. (1), "Operational Auditing", (The Internal Auditor, Vol.17, No.1, March 1960), p.28.

financially-oriented audit which focuses attention on the management accounts.⁽⁴⁷⁾

Two other suggested audit approaches for conducting these more recent types of audit are summed up in the terms "functional audit" and "departmental audit". The functional audit approach may be very extensive or it may be much simpler and confined to a relatively narrow topic. It cuts across departmental lines and literally follows the function or activity wherever it is performed throughout the organisation.⁽⁴⁸⁾ A departmental audit approach selects for review all activity under the control of a given managerial position. This may involve a review of several unlike activities.⁽⁴⁹⁾ From this point of view the departmental audit approach is sometimes referred to as the 'responsibility audit'.⁽⁵⁰⁾

Less frequent is the so called 'management studies' approach.⁽⁵¹⁾ This is the case when a top-notch internal audit team participates in a special study involving making an evaluation of, and offering recommendations for

47 Gustafson, G.A., "Management-type Auditing", (The Internal Auditor, Vol.31, No.4, Nov./Dec. 1974), p.37 et seq.

48 Johanson & Salvage, "Administrative Office Management", (Mass., Addison-Wesley, 1968), pp.488-501 esp. p.498.

49 Idem.

50 Walker, W.A. and Davies W.R., "Industrial Internal Auditing", (New York: McGraw-Hill Book Co., Inc., 1951), p.4.

51 Sawyer, L.B. (1), "The Practice of Modern Internal Auditing", (USA: The I.I.A., Inc., 1973), p.306.

improvements in, problem areas of the business.

All these audit styles or modes are valid in that they label audit approaches which in turn indicate the direction or scope of audit work undertaken.

Describing operational audit as an 'attitude of mind' or a 'method of approach' makes it possible for the internal auditor to approach his audit in *any* area from whatever standpoint he wants - financial, operational or management. This theme is implied in most of the explanations of operational or management auditing. For example, Sawyer pointed out that:

"One way of getting into the heart of operational auditing is by establishing what it is not. Operational auditing is not a separate discipline that uses special auditing techniques. It is rather a state of mind ... a different posture ... another way of approaching audit problems. ... Managers are concerned with every phase of the company's operations; and the internal auditor, as the eyes and ears of management, should be similarly concerned."(52)

1.5.2 Accepting that management-type audit exists between internal auditors at least as an idea, to what extent have these ideas been implemented? A survey of the literature indicates that various researchers have reported empirical evidence highlighting a positive answer to this question. For instance, in a study made in 1963, of the 177 organisations participating, 151 organisations were engaged in operational auditing. (53)

52 Sawyer, L.B. (2), "Internal Control - The Internal Auditor's Open Sesame", (The Internal Auditor, Vol.27, No.1, January/February 1970), p.39.

53 Walsh, F.J., Jr., "Internal Auditing", Studies in Business Policy No.111 (New York: N.I.C.B., 1963), p.48.

In 1968 the I.I.A. carried out a survey of internal auditing practice in the USA which disclosed an evident trend toward a broader scope for the internal auditing activity; some of the significant results of this study show that: (54)

1. Most internal auditors are extending the scope of their work into non-financial audit areas.
2. The majority of internal auditors stated that they have unlimited scope in deciding what and how to audit.
3. Many organisations are using internal auditing to appraise operating as well as financial systems.

Another study found that 83% of the 53 organisations responding to a questionnaire performed operational audits. The questionnaire was mailed to 114 organisations which were members in the Philadelphia Chapter of the I.I.A. till the end of 1969. (55)

With assistance from the Australian Society of Accountants, in 1973 E.J. Glenn carried out a survey of internal audit practice in Australia. Some of the important findings of this survey indicate that: (56)

54 The I.I.A. (6), "Survey of Internal Auditing: 1968", Research Report No.15, (New York: The I.I.A., Inc., 1969).

55 Choi, J.T. (2), "Operational Auditing: Part 2", (The Internal Auditor, Vol.28, No.3, May/June 1971), p.44.

56 Glenn, E.J., "Internal Audit Practice in Australia: 1973", Bulletin No.17 (Melbourne: Australian Society of Accountants, 1974), pp.36-37.

1. A substantial majority (73%) of organisations covered by this survey report complete audit of all major functions, suggesting that a much wider role for internal audit, similar to that found in the American survey (1968) is developing in Australia.
2. Most internal auditors were not required to report on individual employees' performance and it appeared that there could be a slight trend towards reporting on functions and activities rather than on people.

This survey may be compared with a similar study which was made by the German Institute of Internal auditing and published in 1974. In this study, questionnaires were mailed to 2500 firms throughout the Federal Republic of Germany of which 19% replied.

Among the results obtained are the following:

"During the past ten years, it was found that 'classical' audits in finance and accounting have expanded into other areas of company activities. Emphasis has shifted to operational auditing. These other areas include administrative departments, personnel, and employee benefits (86%); inventory management (85%), EDP (76%); production and engineering (68%); and marketing (61%)."(57)

An empirical study in British industry has also disclosed a similar pattern. In 39% of the 65 organisations participating in the study, all areas and operations are

57 Kropp, H.F., "Internal Auditing in the Federal Republic of German", (The Internal Auditor, Vol.33, No.2, April 1976), pp.52-53.

subject to internal audits. In 41% of the organisations, operational areas are also covered to various extents. 15% of these organisations indicated that they had plans to extend their audit coverage to more operational areas. (58)

Appropos the above, a result of a questionnaire on internal auditing issued by The City University, London, in 1974 was that "All our sample internal audit departments are engaged in functional and operations audits." (59)

It is also interesting to note that another survey was carried out by the I.I.A. and published in USA, 1976; it disclosed that 'operational auditing' represented roughly 50% of internal auditing effort. (60)

In 1976, another study, also carried in the USA found totals of 55.82% for internal audits using financial data and 44.18% for internal audits based on non-financial data, these percentages being relative proportions of audit effort assigned to these types of audit. (61)

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- 58 Low, E.A. and Shahin, I.O., "An Analysis of Behaviour in the Internal Auditing Process", (The I.I.A., Yorkshire Chapter Seminar, Monk Fryston - 22nd March, 1974), p.2. NOTE that the five U.K. Chapters were recently amalgamated in 1975 to form one large U.K. Chapter.
- 59 Chambers, A.D. (1), op. cit., pp.40-42.
- 60 The I.I.A. (7), "Survey of Internal Auditing: 1975", (Florida: The I.I.A., Inc., 1976).
- 61 San Miguel, J.G. et al "Extending the Audit Function: A Survey and Framework for Analysis", Working Paper, Division of Research, Graduate School of Business Administration, Harvard University, 1976), pp.5-10.

In 1976 a survey of internal auditing in the UK was carried out by the UK Chapter of the I.I.A. In this survey 82% of responding organisations stated that their internal auditors examined *all* company activities. (62)

1.6 . Conclusions

There are some significant trends revealed by the history of internal auditing. These trends indicate:-

1. Internal auditing is a relatively new occupation with roots running well into the past. There were a number of factors which helped to shape it, including (and probably of the greatest significance) the following:-

- (i) Separating of management from ownership

This factor resulted in establishing many internal audit departments as a separate protective function within organisations.

This was in response to both (a) the owners' need for additional protection - besides external audit - of their capital investments made in the company, and (b) for professional directors' protection need as to their responsibility for the protection of resources of the company.

62 Smallbone, M.J., et al (1), "A Survey of Internal Auditing in the United Kingdom", Research Report No.1, (London, The I.I.A., U.K. Chapter, 1976).

(ii) Expansion of the span of control

As a consequent result of (a) the increase in size and complexity of modern business organisations, (b) geographical dispersion of operations, and (c) decentralisation of controls, the expanded span of control faced by management has helped in the emergence of internal audit functions in many organisations as an aid to increase the effectiveness of management in controlling the company.

(iii) The development of internal control

Efforts made by managements and external auditors in developing and improving the systems of internal control have increased their perception of the benefit of a sufficient internal audit department in the organisation. This has been used by management as a helpful means to contain the external auditors' fee; the external auditors have used it as a means of reducing their routine and mechanical audit work, permitting substitution by a less time-consuming and less tedious audit approach.

(iv) Changes in external auditing techniques

The adoption of sampling procedures, and reliance on the system of internal controls (both being major changes in external auditing technique) have resulted in fostering a recognition of the importance of internal auditing as a useful tool to ensure that

systems of internal control are sound and that financial statements are accurate. Thus many public accountants have recommended that an internal audit department should be established in the company. Here, the public accountants have relied on internal auditors and co-operated with them. The importance of this result is that it does illustrate a significant pattern revealed by the history of auditing, in that most internal auditors have been recruited from the accounting profession in general, and mainly have accounting background. A pattern which seems largely to have continued until recently - see: Sec. 4.6.3.3.

2. In its formative days, internal auditing was almost entirely protective in nature, its chief objective being strongly related to the parallel objective of financial auditing performed by the public accountants which was mainly detection and prevention of fraud and errors. The scope of the internal auditor's activity was confined merely to the accounting matters and concentrated upon the system of internal check. Emphasis was placed upon fraud detection in the history of auditing and, as a result, many employees viewed the auditors, particularly the internal auditor, as spies. This is an inherited description that internal auditors have had to carry

with them since those old days, and probably still suffering from its impact nowadays.

3. The protective feature of the internal audit function was and still is highly significant, and all the indications are that it is here to stay. The internal auditor's services are based on the needs of the organisation he serves. In this regard, the auditor's traditional protective responsibility (which in the past was usually interpreted to mean fraud detection) should become more broadly interpreted as a constructive responsibility for providing protection against waste of many sorts, and generally to help management operate efficiently and effectively.
4. The constructive, expanded role of the internal audit function suggests that it is appropriate for the internal auditor to go beyond traditional financial areas into any phase of business activity where he can be of service to the organisation. This does not mean less emphasis on protective auditing, but rather that additional efforts will be expended on broadening the usefulness of internal auditing.
5. The role of The Institute of Internal Auditors in developing the professional practice of internal auditing cannot be denied. However, we should not lose sight of the fact that the I.I.A.'s Statements of the Responsibilities of the Internal Auditor, and even the new Standards, set forth the purposes and philosophy of internal auditing *as it should be*, as

judged by the most advanced and progressive thinking of the leaders of the profession, rather than as it is. Furthermore, the pronouncements of the I.I.A. are general recommendations only: the Institute has little authority to enforce them, though they seem widely accepted in the literature. Accordingly, what really counts is the extent to which the I.I.A.'s recommendations are carried out by internal auditors in actual practice.

6. In accordance with the preceding discussion, the situation of internal auditors with respect to what is called 'management-type audits' can be summarised as follows:-

(i) Internal auditors appear quite definite that management-type audits are not for the purpose of evaluating people as to the performance levels achieved, but rather for the purpose of evaluating management systems (at any level) that enable an enterprise to be managed and to function.

(ii) It is reasonable to conclude that there is an important linkage between the so-called financial and non-financial areas, and that it is desirable to recognise and to take advantage of that linkage. At the same time, there is no reason why all of internal audit effort cannot be shaped, with various types of emphasis, to serve company needs in the total operational sense. It is believed, therefore, that both financial

auditing and management-type auditing can find full expression within the framework of internal auditing. It is not the specific approach of internal audit that counts for this largely depends upon the particular internal audit assignment. It is what internal auditing should do and be - a modern, up-to-date, and future-oriented appraisal activity to serve company needs in the total operational area in most effective way.

- (iii) It is also reasonable to conclude that present day theory of internal auditing reflects major progress in the scope of coverage of the operational activities and the level of service in individual operational areas. Much of this progress is credited to the efforts of the internal auditing profession itself which, through its own self development and dedication, has set the stage for a continued enhancement of role.

Nevertheless, the question which is often raised is what is the basic justification for the internal audit to extend its service activity in these broader operational directions? Though some empirical surveys have contributed in this context, there are still many detailed matters to be explained, and if we are seriously trying to grasp the nature and scope of current internal auditing, we should

aim for adequate explanations indicating what internal auditing should be doing which it is not doing, and what it should not be doing which it is doing: and this introduces us to the next chapter.

CHAPTER 2

PROBLEMS OF INTERNAL AUDIT'S EXTENDED SCOPE AND AN ELABORATION OF THE RESEARCH INQUIRIES

The accounting and financial areas were the original concern of internal auditors and continue to be a major area of interest. Their competence in auditing these areas is not seriously challenged. It is the extension of the audit function beyond its traditional bounds which offers new avenues of service and correspondingly raises the most serious hazards.

The purpose of this chapter is to explore the problems created by the extended scope of internal auditing and the effect which this role change might have on the internal auditor's work.

Information deduced from this discussion will be used as a basis for identifying the theoretical framework of the research undertaken. The discussion will be developed according to the following headings:-

1. Interpretations of the internal audit 'appraisal'.
2. Subjection of management levels to internal audits.
3. The nature of internal audit points.
4. Management backing and approval.
5. Summary of matters to be explored.
6. Statement of research objective, areas, and hypotheses.

2.1 Interpretations of the internal audit 'appraisal'

The enlargement of the scope of internal auditing to include the audit of non-financial "operational" areas involves acceptance of the concept that just as financial controls can be appraised, so the controls established and administered by non-financial functions within an organisation may be subject to the internal auditor's appraisal in a similar way. Disagreement persists, however, as to the exact form this expansion of the internal audit appraisal activity should take, though the "appraisal" feature is characteristic of all of the internal audit activities.

Some people believe that audit appraisal should apply only to the systems of *control* employed in the non-financial areas of the organisation rather than to a more expanded general appraisal of the functions in their entirety. In their opinion, principles of control are the same regardless of the functional area to which the controls are being applied and the technical competency of internal auditors in appraising the adequacy and effectiveness of internal controls can equally be applied in all other functional areas as well as in the areas of accounting and finance.

A majority support for this limited interpretation of the audit appraisal seems to exist, and it does seem likely that more co-operation would be available from personnel being audited at all management levels so long as internal audit appraisal is confined merely to systems of control.

From a practical point of view, any operating executive who is helped to control his operations is likely to be quite cordially disposed towards audit - in contrast to a situation where the internal auditor might be charged with the responsibility of appraising the overall efficiency and effectiveness of operating functions.

According to this view, it is consistent that the internal auditor would not be expected to appraise the *technical* aspects of operations which might be encountered during his audit. He is qualified as an expert in the field of controls and his only real proficiency is in the area of appraisal of the way in which activities are administrated.

In this context, Meigs and Larsen pointed out that:

"The operational audit is in no sense an attempt to appraise the technical skills of engineers, machinists, geologists, or other specialists in the performance of their work. Rather, it is concerned with the question of whether the persons responsible for managing these technical activities have provided adequate administrative controls to ensure that the quality of the work will be up to standard, that schedules will be met, and that the work will be done economically."(1)

Meigs and Larsen went on to add that:

"The internal auditor is qualified as an expert in the field of administrative control. There is no need for him to become a specialist in any of the specific types of activity with which he is concerned in order to do an effective job of appraising the administrative controls over those operations."(2)

1 Meigs, W.B. and Larsen, E.J., "Principles of Auditing", (Homewood, Illinois; Richard D. Irwin, Inc., 1969), pp.832-833.

2 Idem.

R.E. Seiler, also emphasised this view quite explicitly when he pointed out that:

"Operational auditing will and must remain within the framework of control, ... If the internal auditor steps beyond the purview of controls, he becomes a specialist in operations and passes on the efficiency and effectiveness of technical operating decisions. ... Should an auditor move beyond the range of appraising and evaluating controls and enter into the area of judging the correctness of technical decision, or how wise a business decision may have been, he will automatically be crossing the line between what is a question of judgment and what is a question of fact. The auditor can not help himself or his company if he attempts to measure the validity of business judgment."(3)

Needless to say that those who support this limited interpretation of internal audit appraisal by no means consider the review of personnel in charge as part of the internal auditor's appraisal activity (see: Sec. 6.3 et seq).

Nevertheless, it could be argued equally as effectively that the appraisal of controls cannot be effected without appraising the efficiency and effectiveness of functional areas, including personnel in charge, as to the performance levels achieved.

With respect to what the I.I.A. professes, the current revision of the Institute's *Statement* (1971) suggests that "appraising the quality of performance in carrying out assigned responsibilities" is one important activity of the internal auditor. Also the new Standards (1978) clearly indicated that the evaluation of the quality of performance in carrying out assigned responsibilities should be included in the scope of the internal auditing activity.

3 Seiler, R.E., op. cit., pp.55-56.

In this case, the term "appraisal" implies a duality - appraisal of the systems of control, and appraisal of management functions including an evaluation of their efficiency, effectiveness, and individual performance.

Indeed, there is a powerful argument that the internal auditor cannot afford to by-pass the appraisal of operating performance from the standpoint of efficiency (i.e. the ratio of inputs to outputs) and effectiveness (i.e. the relationship of outputs to the desired goals of the organisation, see: (1) Appendix (F)), if he wishes to be recognised as an integral part of management organisation team.

A.J. Gregory pointed out that:

"The efficiency of an organisation is largely dependent upon two factors - personnel and operating performance. These factors are closely related and the auditor must recognise this relationship. ... the internal auditor, by the very nature of his work, is in an advantageous position to appraise employees and their performance. ... The auditor will have knowledge of internal controls applying to the work performed by the employees which enables him to determine the manner in which inefficiency in one individual affects the work of others. Likewise, the auditor is in an ideal position to observe whether the employees are working harmoniously as a team toward the objectives the company is seeking, as well as merely performing efficiently as individuals."(4)

Gregory's remarks are interesting because he implies that the efficiency of an organisation is dependent upon personnel and operating performance. In other words, he highlights just those very two issues that internal auditors have been fighting shy of getting involved at least until recently - namely the review of technical

4 Gregory, A.J., "Evaluating Operating Performance and Personnel", (The Internal Auditor, Vol.9, No.2, June 1952), pp.33-34.

aspects of operational areas, and secondly, the review of personnel responsible for these operational areas - see: Sec. 6.4.4 and 6.4.5.

The issue as to whether or not the internal auditor can review and evaluate technical aspects of operations is very complex indeed. The various types of operation in all companies cover a wide spectrum. Some are quite routine while others are very complex, technical, and requiring special experience and knowledge for their execution. In many of these situations the question is often raised as to how any individual like the internal auditor, who is not specifically trained in the particular area, can be helpful. This is especially true when terms like "appraisal", and "evaluation" could be defined to mean "to estimate the value of".

Such estimations of many non-financial aspects could only be made by a specialist in some field other than accounting and finance.

It seems that the basic impediment to the wide acceptance of the internal auditor's involvement in auditing the *technical* aspects of operations comes from the fact that most internal auditors have traditionally been accountants. The UK Survey (Research Report No.1) and the USA Survey (1976) indicate the monopoly, though a weakening monopoly, of the accountant in internal auditing:

Accordingly, "I think most people would say that because an internal auditor who is an accountant has skills of a technical nature in accountancy, he is legitimately entitled to appraise the technical aspects of accounting operations. Therefore, why should not internal auditors, if they are extending their scope to embrace other operations outside the accounting and financial areas, appraise the technical aspects of those other operations as well? Of course, to do so, it can be argued that they need to employ specialists in these other operational areas. But then if auditors are auditing these other operations, why should the accountant have the monopoly of the internal audit field? My article on the audit of Research & Development mentions that everyone surveyed considered that the technical aspects of R & D were outside the scope of internal audit; but this may have been a consequence of most of the internal auditors being qualified accountants.

The fundamental question is, should internal auditors be concerned with the technical aspects of the operations that they are auditing? Do the technical aspects have any bearing on whether or not internal control is satisfactory? If, on the other hand, we reject the view that the internal auditor is only interested in internal control in a narrow sense, and substitute the view that the internal auditor is interested in the efficiency, effectiveness, economy of operations in all aspects, then I think the argument is made that the technical aspects are relevant."⁽⁵⁾

This viewpoint points to the desirability of having audit departments staffed of people with backgrounds in various areas of business. At the same time it raises the question as to whether non-accountants on the staff of internal audit departments have a favourable impact on the expansion of its activities into non-financial areas? It is a possibility that deserves consideration (see: Sec. 4.6.4 and Sec. 5.3.3).

5 Chambers, A.D. (7), "Written Comments provided by Mr Chambers on this work" (Memorandum, Sep. 19, 1978, TCUBS). Article referred to: "The Internal Audit of Research and Development", (R & D Management, Feb. 1978).

Appraisal of the overall performance of various operating departments within corporations gives rise to certain benefits to organisations. This is particularly true of the larger organisation where management develops the broad plans and policies of operations, and must delegate the responsibilities for carrying them out to others. Here, it is the responsibility of the internal auditor to assist management at higher levels in determining that its delegated functions are being performed satisfactorily and that the organisation is operating efficiently.

Senior management at higher levels is also keen to increase its ability to see into areas which might not otherwise be viewed by these levels of management: the internal auditor in such situations serves as a supplementary resource to bridge the organisational gap in the company.

It could be argued, however, that the auditor's conclusions regarding any evaluation of overall performance of operating departments is likely to be somewhat subjective due to a lack of precision in measurement and standards of performance. In this context, the development of standards of performance is a very difficult procedure, yet they ...

"Can be found in job instructions, company directives, budgets, product specifications, trade practices, minimum standards of internal control, generally accepted accounting principles, contracts, statutes, sound business practice, or even in the multiplication table."(6)

6 Sawyer, L.B. (1), op. cit., p.276.

It should be borne in mind that such an evaluation is made for the benefit of management in the conduct of a business and there is no question of liability to third parties which might arise in the context of an independent evaluation of management performance (see: Sec.8.5).

It does seem that the review and evaluation by the internal auditor of the overall performance of various operating departments within the organisation will be appreciated and welcomed by higher management levels. Does this mean that management at other levels will accept such review without undue resistance? Perhaps more important, are management at higher levels also prepared to be subjected to such reviews?

This brings us to the discussion which follows.

2.2 Subjection of management levels to internal audits

Internal auditing may be considered to be a control device for the purpose of appraising all other controls and performance. Actually, there are many forms of control between the various levels of management, besides many other forms of control within each level. By one means or another, each level must control that level immediately below it in order that proper control over the organisation as a whole may be effected.

In this context, the question of at what levels of management the internal audit function is to conduct its audits is a debatable issue. Management levels, for the purpose of this discussion, may be broadly defined as administrative-, executive, and lower managerial-levels (see: Sec. (4) Appendix (F)).

Earlier discussion concerning the development of internal auditing has indicated that the first internal audit assignments usually originated to satisfy very basic and sharply defined operational needs. A major emphasis had been placed upon protective company needs, and management had therefore delegated to the internal audit staff the responsibility for appraising the measures instituted to prevent and detect fraud and accidental errors; and to detect and report non-compliance with the organisation's policies, plans, and procedures.

This audit work, due to its very nature, is directed toward lower managerial levels, and is basically a review of past actions or events, and to a large extent has an accounting and financial orientation. It does appear that most internal audit work lay within these boundaries. It is interesting that such auditing is readily acceptable to management at both administrative and executive levels. Why is this so? There are good reasons. First, this type of audit is "historical" in nature - an examination of something already done, with an appraisal of its effect is much easier than an examination and appraisal of something that is just proposed and has not yet been done. Secondly, the accounting and financial control systems are the creation of management at higher levels. All too frequently, management at these levels assumes past compliance with established systems to be a measure of their success. Thirdly, audits of accounting and financial areas are historically within the province of accounting

and finance and internal auditors grew from these backgrounds.

Internal audit work is readily acceptable to management at higher levels - so long as the internal auditor does not attempt to extend the scope of his appraisal activity into upper levels! (See: Sec.5.3 and Sec. 6.4). To illustrate, since internal auditing is concerned with evaluating all controls and performance, then an audit of a particular operational area with the expressed objective of reviewing and evaluating its efficiency and effectiveness, is a direct audit of executive levels' application of, or adherence to, administrative levels' plans, policies and objectives. Why do some executive managers oppose internal operational auditing?

Opponents usually point out that to pursue a line of investigation outside the traditional financial parameters of internal auditing would demand the services of personnel who are well experienced in technical operational matters.

No doubt audit departments with the relevant specialist skills amongst their audit staff are in a better position to tackle operational audits (see: Sec. 5.3.3). However, there is an element of truth in the argument that when an internal auditor is involved in operational audits, he is often not appraising a system established by management; he is in fact appraising management's compliance with the system. Hence, if operations are found to be weak, or inefficient; the report that flows out as a

result of the audit is a report on the management in charge of that functional area reviewed. That is why some management members specially at executive levels come to resent the internal auditor's review and appraisal in non-financial areas.

If this is so, how could one explain the development of what is so called 'operational auditing' in many organisations? The internal audit's involvement in auditing non-financial so-called operational areas, has developed simply because management at administrative levels felt the need to use the internal auditor's techniques in appraising the effectiveness of management control systems in areas beyond those strictly of an accounting/financial nature.

Failures on the part of employees to follow the organisation's policies are of great importance to administrative levels, and the reason(s) for failure to follow established procedures are of equal significance, for they may indicate that the decision models themselves are ineffective. Administrative levels would also be vitally interested in suggestions tending to reduce costs or eliminate unnecessary losses; and any indication of duplication or, omission or overlapping of work is of equal interest.

Management at administrative levels relies upon the 'eyes and ears' of its internal auditor in reporting on the conduct of business affairs at remote locations of the business empire. This in effect becomes a true audit

of management systems in its broad sense, because the internal auditor reports back to management, specially at administrative levels, something more than on the accuracy of the reported financial results: he is expected to indicate as well his opinion on the overall performance of an 'operational' area which may seldom if ever be visited by higher management members personally - see: 6.4.2.

It is appropriate now to examine the feasibility of any suggested expansion of internal auditing work to include tasks of administrative levels. R.H. Van Voorhis et al pointed out, that to the extent that the appraisal of performance may be made through a review of compliance with established criteria or standards employed in the organisation, the internal auditor may well appraise the quality of management at all levels.⁽⁷⁾

This might be the case at executive and lower levels but it is not that easy at top levels because internal controls are the creation of management at administrative levels. These levels have established the system expressly to make sure that the levels below carry out their commission. Consequently, the success or failure of the system can be judged relatively easily - all that need to be done is to compare actual results with planned results, or in some cases, to determine the degree of compliance with established criteria or standards.

7 Van Voorhis, R.H. et al, "Using Accounting in Business", (Belmont, California: Wadsworth Publishing Co., Inc., 1962), pp.379-380.

Such has to be the case at management levels below those of administrative levels. But at these later levels, there is no structure of control imposed by higher authority within which the top managers can operate. Such controls as exist at these levels must be self-imposed. At most, compliance with such controls cannot be regarded as a measure of success at these levels. Other measure(s)⁽⁸⁾ must be available to judge the success of management performance at top levels.

It could be argued, however, that ...

"in any company there should be stated objectives and overall policies which govern action at an administrative level and which may be the starting point of the audit of 'top management'. Accordingly, ... it is perhaps possible to conceptualise of internal auditing the various functions or operations right to the very top because the executive director at the top of the function or operation in fact is not at the top of the 'tree' in the sense that above him is the Board and above that are the shareholders and also the Memorandum and Articles of Association."⁽⁹⁾

Nevertheless, it is here that the same obstacle is found as in the suggested expansion of the attest function to evaluate management performance - that is, the lack of an established body of standards for the evaluation of top management abilities and performance - see: Sec. 6.4 et seq.

8 For more detailed description of this viewpoint see: Appley, L.A., "Standards of Management Performance", see also: Blair, W.T., "Appraising the Board of Directors", Both in: Greenwood, W.T., "Business Policy - A Management Audit Approach", (London: The Macmillan Co., 1967), pp.55-58 and pp.59-78.

9 Chambers, A.D.,⁽⁷⁾, loc. cit.

At executive and lower managerial levels, unlike at administrative levels, standards have largely been well developed to permit their fairly productive use in evaluating management performance. Also the recent developments in the control concept - see: Sec. (1) Appendix (F) - make it possible to evaluate managerial performance of executive's responsible for separate functional areas in the organisation.

Application of these standards to administrative levels, however, does not seem feasible because the demands of such positions are too ill-defined and broad in scope to the extent that they do not lend themselves to measurement which is precise enough to render an objective opinion as to the effectiveness of management performance at administrative levels.

On the other hand, at the levels below that of administrative level, when performance is reviewed and evaluated against established criteria, this may allow the appraisal of present as well as future tasks; and areas of weakness requiring strengthening for current and future endeavours may be sought.

Such evaluations are of great importance from the standpoint of management at administrative levels, simply because any devices that might sharpen their judgement as to the performance of the levels below them are desirable, and these higher levels would - if farsighted - obviously be keen to find competent personnel in the organisation to render this service - and that is the natural role of the internal audit staff within an enterprise. As in one

sense top management have not future jobs to aspire to, having 'arrived' at the top, and as they are also developers of men rather than being primarily motivated to develop themselves, administrative levels by these very attributes of their position may be excluded from internal audit's appraisals.

Among other reasons which increase the difficulty of conducting such internal audit's appraisals, is the extremely touchy situation where the top man would have to be appraised by someone subordinate in some way at least, unless the appraisers were completely independent.⁽¹⁰⁾

In conclusion, the basic function of the internal auditor is to help to improve management controls and to increase the effectiveness of management's ability to manage the organisation; the suggested expansion of the internal auditor's role as to appraise management systems (including evaluation of the quality of performance in carrying out assigned responsibilities) presents a potential means of extending internal audit work beyond the financial audit into non-financial 'operational' areas. This extension neither results in a marked loss of independence nor in significant problems of competence for the internal auditor - such as would occur if he was to attempt a true audit of administrative levels' performance - see: Sec. 8.2.3 and 8.2.4.

10 Heyel, C., (2), "Appraising Executive Performance", (New York: American Management Association, 1958), p.17.

2.3 The nature of internal audit points

Based on the results of his review, the internal auditor should be able to defend his professional judgement for the activities he has reviewed. His professional judgement is his overall opinion which provides a brief but self explanatory assessment of the conditions he has found. This is the most natural demand that is imposed upon the internal auditor by all management levels but perhaps most of all by those at administrative levels. Needless to say, any failure to provide this judgement deprives management of an important service.

Management expects an absolute integrity from auditing the effectiveness of internal management controls; and this puts internal points (i.e. audit findings and recommendations) in a special, significant place in the process of internal auditing. The nature of internal audit points made to management, and what they are intended to achieve is the main purpose of this discussion.

Specifically, the discussion addresses itself to the following questions:

- (i) To what extent can the internal auditor produce dependable audit points that management can act upon?
- (ii) Does the internal auditor's involvement in identifying problem areas and making recommended solutions, encompass any involvement by him in the design of proposed change(s)? If so, to what extent does this affect the independence of the auditor?

- (iii) Should the internal auditor be involved in pre-event audits?
- (iv) What is the best possible style of internal audit reporting practice under which audit points can be made with a positive impact on the potentially touchy auditor-auditee relationship?

2.3.1 The audit findings are the source from which all audit points or recommendations flow. Audit findings may describe and explain a satisfactory condition that warrant mention in the audit report; or they may set forth unsatisfactory conditions that need correcting.⁽¹¹⁾

Some people believe that the internal auditor cannot be in a position where he can contribute dependable audit points or recommendations. The reasons for this - in their opinion - are not difficult to see ...

"To begin with, the operations auditor does not do an intensive study. He engages substantially, in sampling activities. In the second place, when the survey phase of the audit is over, he must spend the time left to define the problems he discovered in the most precise, meaningful terms possible so that management can decide what priority the problems should be given in using the resources of the enterprise. In the third place, he does not have the knowledge needed to provide solutions management can trust. After all, the process of finding the best solution to any problem worth solving is a complex, time-consuming one involving, among other things, developing alternatives, testing them, and selecting the one with the most favourable trade-offs. It is not an activity the operations auditor has either the time or, in most cases, the best qualifications to do."⁽¹²⁾

11 Sawyer, L.B. (1), op. cit., p.370.

12 Lindberg, R.A. and Cohn, T., "Operations Auditing", (New York: Amacom - A Division of American Management Association, Inc., 1972), p.11.

Nevertheless, a view common to personnel in units or functions subject to audit is that, internal auditing is critical by nature, and because audits are performed by persons outside the unit being audited, audits usually lead to the discovery of problems; there is then a tendency to involve the auditor in the design of change. This view stems from the defensive position, 'OK Mr. auditor, if you're so good at finding problems, you ought to be good enough to tell us what the solutions are?'. It must however be pointed out that some internal auditors are actively experimenting with audit involvement in the design and implementation of procedures which are a response to the auditor's recommendations,⁽¹³⁾ as this so-called participative auditing has been shown to improve the acceptability of both the auditor and therefore of his recommendations, and consequently lead to improved levels of internal audit job satisfaction.^{(14), (15)}

The most fundamental question is not whether the internal audit function carries with it a responsibility to discover and inform management of the enterprise's problems, or whether its main purpose is to assist

13 Allen, B.L., "Can the Participative Audit Approach Improve Job Satisfaction?", (The Internal Auditor, Vol.35, No.4, August, 1978), pp.59-64.

14 Idem.

15 Mints, F.E., "Behavioural Patterns in Internal Audit Relationships", Research Report No.17 (Florida: The I.I.A., Inc., 1972) being a summary of the author's Ph.D. thesis from the School of Business of the University of California.

management to solve problems by recommending courses of action including solutions. It is to what extent the internal auditor can contribute dependable audit points that management can act upon? (see: Sec. 7.2 et seq).

It is fully admitted that, due to the very nature of his work, the internal auditor will discover weaknesses somewhere in the audited areas; such being the case, he should be able to identify these problems and bring them to the management's attention. This is the minimum requirement if he is to be an adequate auditor.

A valuable contribution which should be offered by the auditor is his ability to concentrate on prevention of problems rather than on their cure. Through this management can detect the danger signals that signify future problems and can introduce early corrective actions.

But, if the problem has already happened, and so long as the auditor has confidence that it is a real problem, should the auditor be confined to its identification, or might this also be coupled with recommended solutions? Generally speaking, the answer might be found in the nature of any proposed recommendation.

Conceptually, audit recommendations fall into one of the following categories:

- "- Specification of actions that should be the solution to the problem.
- Specification of actions that should produce the solution to the problem, and
- Specification of actions that should lead to the production of a solution."(16)

16 Churchill, N.C., "Audit Recommendations and Management Audit: A Case Study and Some Remarks", Journal of Accounting Research, Supplement to Vol.4, 1966).

In the first case both the cause of the problem and the cure that should be implemented are known (e.g. having two persons open the morning mail).

In the second case the cause is known but the necessary actions need to be developed (i.e. what can be done to find the solution is known).

In the third case neither the cause nor the proper effective actions are known, but only the areas in which the cause probably lies. All that can be done, here, is to recommend actions that will draw attention to the 'right problems'.

It can be seen, thus, that the nature of the activities examined by the auditor provides a guide to the type of response which the auditor is likely to communicate to management.

Recommendations which are concerned with audits that are of financial nature, as well as compliance audits, for instance, would tend to be dependable recommendations, since the criteria used derive from common concepts of internal control and generally accepted auditing practice with which internal auditors are familiar.

By the same token, in the audit of management systems at operational levels, in which various sets of actions are examined but where the criteria for each is the set of procedures laid down by the management to govern the items processed and the actions taken - the expected audit recommendations would be concerned with either the actions taken (if there was a lack of compatibility between them and criteria used), or with changing the criteria

by those responsible for their establishment. In either case, the auditor may be able to determine both cause and cure of the problem, because of his own expertise and his knowledge of the criteria involved.

In certain cases the auditor, although aware of the problem may feel that it is in the best interest of the organisation to utilise the services of the manager directly responsible for the functional area under review to obtain the solution of the problem area. As Hengst already indicated, it is becoming common practice for internal auditors to seek specialised assistance either from inside or outside the organisation. (17)

However, the recommendation may not even be specific as to cause of the problem but only point to a problem area, as the following comment shows:

"The auditor will encounter many situations in which no definite recommendation may be possible either because his experience does not qualify him to give a definite opinion, or the facts of a situation may not permit a specific recommendation. Here, evaluation is confined to determining whether the established controls revealed a questionable situation to management; if they did - and were recognised by management - no specific action or recommendation may be feasible for the auditor."(18)

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- 17 Hengst, F.J., "Internal Auditing in Europe", Proceedings of the First Conference on Recent Developments in Internal Auditing at the Graduate Business Centre of The City University (London: Feb. 24-25, 1976), pp.39-60.
- 18 Cadmus, B. (2), "Operational Auditing Handbook", (New York: The I.I.A., Inc., 1969), p.31.

2.3.2 Closely related to making audit points which include recommended solutions is the general argument as to what extent should the internal auditor be involved in designing the proposed change (s)? (see: Sec. 7.1.2). This issue often appears in the context of whether Organisation & Methods should be integrated departmentally with internal auditing.

The argument generally advanced against merging is that, if the internal audit department is responsible for designing and supervising the installation of systems, it will be reluctant to criticise those systems during subsequent audits if weaknesses in their operation are revealed which were not realised at the time they were designed and installed. The I.I.A. seems to take this position saying:

"The internal auditor's objectivity is not adversely affected when the auditor recommends standards of control for systems or reviews procedures before they are implemented. Designing, installing, and operating systems are not audit functions. Also, the drafting of procedures for systems is not an audit function. Performing such activities is presumed to impair audit objectivity."(19)

This statement means that the internal auditor should not take a hand in developing, designing or installing procedures that will be subjected to later internal auditing review, to avoid the destruction of objectivity by the creation of vested interests.

Moreover, some people⁽²⁰⁾ believe that framing a recommendation for change later enacted, does not leave the auditor in an independent position even though he

19 The I.I.A. (1), op.cit. p.100-2.

20 Lindberg. R.A. and Cohn, R. loc. cit.

took no hand in implementation (see: Sec. 2.4.3). This is a good argument resting as it does on the internal auditor's natural desire to establish for himself a reputation for objectivity and completely unbiased criticism; however, further thought on the matter gives rise to some doubt as to the soundness of its final conclusion; as the following points show:

- If deficiencies in systems are discovered during an audit, they are bound to be disclosed and commented on in internal audit reports,
- An internal auditor, anxious to be constructive, will almost inevitably make recommendations to overcome these deficiencies in his report. If he does not, management will insist upon such recommendations.
- There is also a strict line of demarcation between prescription and performance. That is, an internal auditor need not hold himself responsible for the actual operation of a new system or take part in the implementation of a proposed system.
- A detailed knowledge of requirements and in many cases of existing systems is necessary before new systems can be contemplated, and this information may be available to the auditor in the course of his duties, arising from his regular reviews of financial and operating areas; thus, he becomes the repository of much knowledge which should be disseminated constructively, as occasion demands. He acts as a clearing house or a conduit, so to speak.

In addition, "... the effective controls have to be designed into the system, particularly the more complex and innovative ones, before the organisation is to rely upon them. The auditor, as a control consultant, needs to assess the original and continued accuracy of important systems from control, audit, security, and efficiency points of view."(21)

Accordingly, the auditor who declines to participate in systems design will have to be content to work in an environment which has less than sufficient control. This will present audit and management problems because management will not be able to afford change in already-automated systems to fit the auditor's 'after the event' ideas of control. Therefore, effective controls should be incorporated into the design of the system and should not be added after the system is functioning.

Whether an auditor makes his recommendations 'before the event' (that is, when the system is being designed) or 'after the event' his independence and objectivity are not jeopardised to a greater or lesser extent one way or the other. Whenever he makes a recommendation he is paddling at least in the shallows of systems design.

2.3.3 Akin to internal audit's participation in systems design is the debatable issue that concerns the internal auditor's involvement in what is so-called as 'pre-event audit' (i.e. internal audits which involve the review and usually the approval of certain phases of company activities before they are actually consummated). In this context, some people believe that internal auditors do not properly

21 Weiss, H., "Reflections on Computers and Auditing in the 1970's", (The Internal Auditor, Vol.28, No.4, July/August 1971), pp.12-29.

perform pre-auditing activities and that by the best standards, such activities are part of the responsibilities of properly established departments within the organisation. (22)

Other people argue that much of the difficulty in establishing a workable system of control really lies in the tendency to regard control as primarily a matter of directing activity from above in order that compliance by lower managerial levels assures effectiveness. But, in a progressive organisation, control may more properly be seen as a matter of setting guidelines to achieve jointly agreed upon ends; accordingly, audit activity might appropriately get into the planning phases of operations in order that goals or objectives themselves may become the means for appraising both past results and guiding the direction of future action⁽²³⁾ - see: Sec. 7.1.2.

The internal auditor's early participation in the design stage is important partly because it is his very engagement at this stage which progressively enables him to contribute to the future functioning of the system.

This might indicate a new departure from the audit of information (i.e. historical events) to the audit of managerial decisions as well, which eventually might require different qualifications and skills on the part of future internal audit departments.

22 Brink, V.Z. (1), op. cit., p.65.

23 Jerome, W.T., "Management Control - Some Audit Implications", The Internal Auditor, Vol.14, No.3, Sep. 1957), p.36.

However, there is still a question which seems to trouble many people - that is the auditor's independence and objectivity in the context of pre-event audits.

In fact, the concept of the auditor's independence itself has been a troublesome concept: this is further discussed under section 2.4.3. Admittedly, however, the established concepts of independence and objectivity have provided good bases for the development of a wide coverage of effective internal auditing. It is, therefore, believed that appropriate independence and objectivity is rightly sought after on a continuing basis. There are, however, some signs of a modified approach in this context which seem to have great promise. One of these was the recent practice for internal auditors to participate in the actual development of modern computerised systems. Some recent studies reported that internal auditors are increasingly involved in this area.⁽²⁴⁾ A further modification of approach observed by some researchers is where the internal auditor participates in the review of current and planned company projects⁽²⁵⁾ - not necessarily in the area of systems development. The rationale here is that the internal auditor with his broad company experience can make an important contribution, and that control operates in the present

24 Smallbone, M.J. (2), "A Survey of Internal Auditing in the United Kingdom", Proceedings of the Second Annual Conference on Recent Developments in Internal Auditing (London: The City University Business School, May 24th, 1977), pp.129-149.

25 Chambers, A.D. (3), op.cit., p.98.

and in the future, but not in the past where, regrettably most audit attention has traditionally been focussed.

It could be argued that this participation in future events is a possible threat to the internal auditor's subsequent independence in the review of the subsequent operational actions, but this may not be necessarily the case or perhaps this may be a proper risk especially if we take into account that when the internal auditor participates with other management groups in the review of future management phases he is doing so because he is in fact the most neutral and uncommitted participant - a special tribute to his independence. On an overall basis, the existence of the threat to objectivity must of course be recognised - it is indeed a possibility that deserves consideration.

2.3.4. The impact of internal audit points made to management upon the auditor-auditee relationship is of special importance in the process of internal auditing within a broader role, and it is often suggested that the internal auditor's reporting emphasis should be shifted from inspectorial, compliance auditing (in which the auditor has an error prevention and detection role) to one which also embraces advisory auditing, that is where the internal auditor seeks to make constructive recommendations for the improving the systems of control so as to assist in achieving overall organisation goals.⁽²⁶⁾ Nevertheless,

26 Ibid., p.97.

there are dissenting views on the adoption of this new audit role and a conflict has been observed between the two roles,⁽²⁷⁾ (see: Sec. 7.2.3).

In fact the problem of role conflict has its deep roots in the history of internal auditing (see: Sec. 1.3), and as being a "staff" function might add many other difficulties to internal auditing. Staff authority relationships were originally thought of as those relationships which are used to support line authority relationships within the organisation, (see: Sec. (8)(d) Appendix (F)). In light of this, it is with the word "support" that the internal auditor's service might be identified.

On the other hand, since the auditor's work is generally considered to be to review, appraise and report - thereby assisting management in co-ordinating the performance of the organisation with its objectives - internal auditing might be viewed as a control-advisory staff authority within an organisation.

Keeping this in mind, it is already known that every organisation consists of a group of people working together for a common purpose. To accomplish this common purpose, it is necessary that social skills (i.e. the ability to secure co-operation and co-ordination between people) should be nurtured and developed.

In this context, like any function in the organisation, the efficacy of an internal audit function

27 Idem.

depends largely upon the relationship which exists with all those with whom it comes into contact. In practice, however, the harmonious working together of a management team encounters roadblocks. There will be honest differences of opinion on identifying and utilising the staff character of internal auditing. The overuse of the control-staff character involved in the work of internal auditing will lead to many line managers to see the internal auditor as an inspector or a policeman. Also, a general complaint among line managers is that, even when he works as an advisor, the internal auditor tends to make audit points which relate to weaknesses observed (i.e. criticisms) with little emphasis on reporting favourable findings (i.e. praise) and as a result internal audit does not preserve its integrity, and is disliked as it accentuates failure. If we add to this that many internal auditors still have strong inner preferences for traditional, old fashion audit styles, and have difficulty in adopting new audit approaches, no wonder it has been recognised that "present auditee relationships still reflect basic conflicts and hostility."⁽²⁸⁾ The failure on the part of some management members to present a cooperative behaviour pattern with respect to the audit activity has its roots, and grew along with, the development of the internal audit function itself.

28 Mints, F.E., op. cit., p.81

As indicated early in this study (see: Sec. 1.2) internal auditing from its very beginning was characterised by being a protective control device rather than a constructive service. Great emphasis has traditionally been placed upon appraising the measures instituted to prevent and detect fraud and error, and to detect and report non-compliance with the organisation's policies and procedures.

In carrying out his traditional inspectorial role, the auditor actually can often even exercise a veto over line actions. Even when the auditor advises, the advice given may be derived from his role as the protector of management; and this can easily be seen by auditees as a sort of activity that carries the implication of inspecting or of work of a policing nature. This is staff authority that is not of the counselling nature. The auditor, under the impact and influence of management's attitude and what it considers his function to be (i.e. mainly protective), undertakes such non-counselling activities: he does not simply advise, he controls. Hence, he restrains line authorities.

The problem is simply that the auditor's traditional role in connection with the protective services continues to be important. Within this scenario, what approaches can be established to improve the auditor-auditee relationship in order to make the audit contribution more effective while not weakening the auditor's protective service?

In response to this vital issue, one of the recent studies on internal auditing and its behavioural implications concluded that auditees do not necessarily see auditors as advisors, except where the advice seems consistent with the traditional inspecting and protective functions. (29)

Another study came to the conclusion that, despite the auditor's attempts at following what they believed to be good human relations practice, auditees still regarded auditors with suspicion and distrust. (30)

This study also indicated that there are two basic fears underlying the reactions of auditees: the fear of punishment or retribution resulting from the auditor's evaluation of the auditee's performance; and the fear of changes in familiar routines brought about by the auditor's recommendations for systems improvements. (31)

Another study disclosed that the participative approach (sometimes known as the teamwork approach or the problem-solving partnership approach) has been suggested to improve conditions. However, this study came to the conclusion that these approaches might solve only part of a problem which, like all human relationship problems, has no complete solution. (32)

29 Morgan, G. and Pattinson, B., loc. cit.

30 Mints, F.E., op. cit., pp.13-14.

31 Idem.

32 Shahin, I.O., "The Impact of Internal Audits on Middle Managers Personal Bias in the Budgeting Systems", Ph.D. Dissertation, Division of Economic Studies, Sheffield University, (Sheffield, U.K.: Sheffield University, 1976).

2.4 Management backing and approval

As the ultimate function of internal auditing is to help the organisation to achieve its objectives, certain expectations should be first met by the organisation before it can obtain the benefits of professional internal auditing.

It is necessary that the internal auditor should have a proper standing in the organisation. Proper standing should be enforced by management support. Management support can be absolute while being represented in many different ways, among which and probably of greatest importance are the following:-

2.4.1 Internal auditing policy statement

Most organisations maintain a set of statements which establish the authority and responsibility of the major positions in the organisation. These become the charter under which each operates. In them is set forth, for the rest of the company to see, how executive management regards the purpose, mission, and authority of each major function within the company.

Consequently, it is considered that a well prepared policy statement of what the organisation expects from its internal audit function, and the authority and responsibilities that the internal auditor is given to carry out such duties, is essential to the smooth operation of the internal audit function within the organisation.

Also, it has been suggested that where management has not documented the internal audit policy, it is essential that the internal auditor takes the initiative,

and prepares a suitable statement and seeks management's approval if necessary after amendment.⁽³³⁾ It is difficult to see how internal audit can operate efficiently across all functions without this type of document.⁽³⁴⁾

2.4.2 Right of access and freedom to review

The internal auditing policy statement would be of little significance if it did not carry with it the right of access to such sources as would enable the audit department to carry out its stated objectives. Closely related to a right of access is the right to review pertinent source material. Unless a reasonable amount of freedom is allowed to the internal auditor he will find that his field is restricted and this can easily lead to reduced efficiency in audit work.

In some situations, however, there are certain areas which management sees as needing to be kept under its direct control and, therefore, certain restrictions on such top management information are necessary (e.g. top security management records, Board matters and minutes, and the like).

These specific areas, due to their very nature, may be restricted. However, such restrictions should be kept to a minimum and management should provide the internal auditor with entree into all areas in the organisation

33 Glenn, E.J., op. cit., p.4.

34 Smallbone, M.J. (2), op.cit., p.135.

The I.I.A. in the new Standards, 1978 made formal recognition of the necessity to have a management policy statement concerning the internal audit function within the organisation when the following statement was made:

"The purpose, authority, and responsibility of the internal auditing department should be defined in a formal written document (charter). The director should seek approval of the charter by management as well as acceptance by the board. The charter should (a) establish the department's position within the organisation; (b) authorize access to records, personnel, and physical properties relevant to the performance of audits; and (c) define the scope of internal auditing activities."(35)

2.4.3 An independent status

Probably, the most important element of an organisation's support for its internal audit department is the provision of an independent status for audit within the organisation. The concept of the auditor's independence has been a matter of lengthy argument in the literature and has described as "a troublesome concept".(36)

It is a rather elusive term which may have different interpretations. For example, Porter & Burton indicated that 'independence' can be a matter of degree. On the one hand, they explained, since the purpose of auditing is to increase the reliability of information through impartial review, the auditor must be sufficiently independent of the auditee so that those who use the audit

35 The I.I.A. (1), op. cit., p.100-1; see also: Carolus, R.N. and Barrett, N.J., op. cit., pp.17-20.

36 Porter, W.T. and Burton, J.C., "Auditing: A Conceptual Approach", (Belmont, California: Wadsworth Publishing Co. Inc., 1971), p.28.

report can be confident of his impartiality; thus, without independence reliability is not assured. On the other hand, 'complete independence' is not consistent with good auditing since ultimate independence could be defined as the absence of any relationship. (37)

Accordingly, 'complete independence' would actually mean that a review would to a large extent be unreliable since an audit could not be successfully performed without reference to the people who make an organisation operates and who represent a significant factor in the 'socio-economic system' which produces the information to be reviewed.

Thus, whenever relationships with people are established, 'independence' can never be considered as being complete.

Such being the case, an internal auditor is even less independent than the so-called 'independent external auditor' since the former is an employee of the company and his relationships with his auditees, who also work for the same company and share with him the end objectives of the company, is even stronger. This in fact may raise the question whether the internal auditor is 'independent' at all and whether the word 'independence' is an adequate term - see: Sec. 8.5.

37 Idem.

The following comment throws light on this issue:

"This concept of 'independence' is a sort of shibboleth of internal auditing. In other words, it is a catch word which signifies something very special to internal auditors, but when analysed does not actually mean very much in itself. ... in my view, there is no such thing as complete independence - it is all a matter of degree. So one cannot say that such and such a thing makes the internal auditor no longer independent because he starts from a position where he isn't and never can be independent in any case.

Neither for that matter can the so-called independent external auditor be independent."(38)

It seems reasonable, therefore, to conclude that the term 'independence' is generally used to mean 'sufficient independence' for the auditor to be fair, or objective, in his review and appraisal and that he is not under undue pressure from his auditees to the extent that this could bias his opinion.

In this sense independence, according to the AICPA, is

"a state of mind, an attitude of impartiality concerning the findings which the auditor brings to light in issuing his opinion ..."(39)

In my view, however, one can never determine a person's thought, hence 'a state of mind' is not an ideal basis on which to place the confidence of management, board, and other interested parties mainly because of its intangible qualities. Therefore, it is important that

38 Chambers, A.D. (7)., loc. cit.

39 Carey, J., "Professional Ethics of Certified Public Accountants", (New York: A.I.C.P.A., 1956), pp.28-32.

as well as the auditor being mentally independent he is seen to be independent, or at least is seen to be in a position in which it is possible to exercise what may be regarded as independence.⁽⁴⁰⁾

As far as the internal auditor's position in the company is concerned, this must be considered as his formal organisational status, i.e., the level in the organisational hierarchy at which the audit department is placed, and the officer to whom the head of the audit department reports. The I.I.A. in the new Standards, 1978 made formal recognition of the importance to have a sufficiently high organisational status, with the following statement:

"The organisational status of the internal auditing department should be sufficient to permit the accomplishment of its audit responsibilities. Internal auditors should have the support of management and of the board of directors so that they can gain the cooperation of auditees and perform their work free from interference.

The director of the internal auditing department should be responsible to an individual in the organisation with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations."⁽⁴¹⁾

The exact person to whom the internal auditor is made responsible varies within organisations. Perhaps, this reveals the reason why the I.I.A.'s statement is couched

40 Lee, T.A., "Company Auditing: Concepts and Practice", (Edinburgh, The Institute of Chartered Accountants of Scotland, 1972), p.68.

41 The I.I.A. (1), op. cit., p.100-1.

in such broad terms. Importantly, however, the I.I.A.'s statement emphasises the need for greater real and perceived independence. This is distinct from the auditor simply having an independent attitude. It highlights that established legitimacy of the auditor's status within the organisation has a direct bearing upon both his perceived independence and the scope of his audit activities within the organisation - see: Sec. 4.6.2.

In the light of this, the head of the internal auditing department should not be responsible to an executive whose own responsibilities are within any one functional area (e.g. the chief accountant) as he would then be responsible to an official whose function he will from time to time need to criticise, and such a position at best would be difficult, and at worst untenable.

Even if one goes further up the hierarchy to the level above, (that is to the level of vice-presidents or other executives who head up the major activities within the organisation) while such a reporting relationship enhances the authority and therefore the independence of internal audit department, it does sometimes cast its shadows upon the auditor's independence.

For instance, if independence is understood as freedom from all dependency, it is unsatisfactory, therefore, to have internal auditing operating under the jurisdiction of the financial vice-president or the treasurer - although it is recognised that this is frequently the case.⁽⁴²⁾ The internal auditor is then

42 Chambers, A.D. (1), op. cit., p.41

placed in the position of having to review line functions under the control of his immediate superior, and consequently may feel under pressure to soften his findings, should they be critical.

Yet, there is a school of thought which holds that if internal auditing is to report within the finance function purely for 'rations and discipline' with a clear right of access to top members of management singly and collectively in order to deliver audit recommendations, and to follow-up upon them, the position may be tenable, particularly if finance has a role as 'co-ordinators of control'.⁽⁴³⁾

In some organisations, however, the head of the internal audit department is responsible to the president or even the board of directors in order to assure maximum independence from functional loyalties, and also to assure adequate authority. The increase in independence and authority in such cases might be more than offset by the inability of the president or the board of directors to effectively supervise his work in view of their preoccupation with matters of more general concern.

It must be pointed out that the concern of internal audit to establish adequate formal authority is indicative of an adoption by audit of a policing role. Policemen have formal authority whereas advisors do not. Policemen have laid down right of access whereas advisors wait until

43 Smallbone, M.J. (2), loc. cit.

they are invited. The more internal audit achieves 'built-in authority' the further they are removing themselves from the auditee and the more reluctant will the auditee be to accept the auditor's findings voluntarily - except under the threat of coercion which, by virtue of the auditor's authority and top management support, is no empty threat. It has been shown that imposed changes have a high rate of failure. (44)

2.4.4 The concept of audit committees

Under any circumstances, two management needs should be satisfied. First, management must be informed and ensured that the organisation's plans, policies, and systems are operating well, executed efficiently, and under control to obtain its objective. From this angle, internal auditing is an invaluable managerial tool that acts as a fact-finding review in order to obtain information on practices and results accomplished, with careful attention to the reliability and validity of the information obtained. Secondly, as with anything else in the enterprise, internal audit should be subjected to the test - does it comprehend the objectives of the enterprise and view the enterprise's activities in the appropriate way? It follows that management needs to determine to its own satisfaction whether internal auditing is operating effectively, and to explore how it may best assist it to meet the organisation's objectives - see: Sec. 8.5.

44 Morgan, G., "Internal audit Role Conflict: A Pluralist View", Management Finance, Vol.5, No.2, August 1979).

Considering that internal audit's involvement in non-financial areas is in a state of evolution, the need for an adequate, effective way to review the effectiveness of internal audit is particularly important. This requires, on the one hand, appreciation by management as to the nature of auditing and of the audit function. Modern internal auditing requires more professional expertise on the part of internal audit, on the other hand.

In view of the first point, it has been suggested that all long-range audit plans should be reviewed by the policy-making level of management and other higher operating levels in the organisation as a means of obtaining management participation.⁽⁴⁵⁾ In support of this is the fact that when top managerial levels accept the audit plans they are in effect committed to them, and thus this provides the auditor an entrée to the functional areas under their control together with the authority to subject them to the audits planned. The auditor then enters those areas and carries on his audit work with the full support of higher management; indeed, almost as if he were under contract to management.⁽⁴⁶⁾

This is, indeed, a good suggestion. However, in practice there are various managerial styles and in some circumstances this suggestion might not be workable

45 Sawyer, L.B. (1), op. cit., p.80.

46 Idem.

While some higher managers may show their appreciation by active participation in establishing internal audit plans, others may show their confidence in internal auditors by giving them a free hand to plan their own audits and to wait for the outcomes.

"Accordingly, top management participation could be interpreted as an appreciation of the internal audit work, whereas little or no participation could not be interpreted as a lack of appreciation."⁽⁴⁷⁾

An enlightened response to meeting the increasing demand from management and other interested parties for more accountability on the part of internal auditing is the concept of audit committee. The audit committee provides an opportunity to reinforce the independence of the internal audit function. When he reports organisationally to an audit committee of the board of directors, the auditor is provided with a proper standing in the organisation, coupled with a virtual guarantee of freedom from undue management influence.

It is expected that the members of the committee - which, in most instances, is composed of three to five non-officer or non-executive directors⁽⁴⁸⁾ - will work very closely with internal auditors. Such a close relationship facilitates the adjustments that internal audit must constantly be making to the changing audit

47 Shahin, I.O., op. cit., p.383.

48 Colegrove, R.L., "The Function and Responsibilities of the Corporate Audit Committee", (The Internal Auditor, Vol.33, No.3, June 1976), pp.16-21.

environment and the new conditions under which internal auditing has to work. This close contact also means more timely access for internal auditors to board members than would otherwise be the case; and, in turn, a deeper understanding and appreciation of the audit function is likely. (49) The members of the committee know that they have a significant responsibility to the other members of the board to inform them of the extent to which internal auditing is operating effectively.

In addition, the general psychological impact of such a known reporting relationship may well improve the auditor-auditee relationship: internal auditors know that they will have to report to the committee, and this will encourage them may be to get fully involved in difficult discussions and critical questions. This provides them a talking point with higher management members, and keeps them on their toes as well. Local managements know that matters which might otherwise never reach the board level, are now likely to come before those members of the board who are on the audit committee. Also, they know that auditors will meet with the committee and will have to respond to its questions with explanations about the actual practice and results; therefore, local managements will be encouraged to be more co-operative in dealing with the auditor and careful in their replies to audit reports.

In sum, the concept of the audit committee represents an opportunity for everyone involved to do a better job and to get adequate results. It is disappointing that a

study has indicated that of the 31 audit committees found to exist in mid-1978 within approximately the top-300 U.K. corporations, only a few had a positive relationship with their respective internal audit departments. Their contact with the internal auditor was only one third as well developed as their contact with the external auditor.⁽⁵⁰⁾ In the U.S., where audit committees are mandatory, and some internal auditors said in 1975 that they reported direct to the audit committee and 77% of internal audit managers meet regularly with the audit committee⁽⁵¹⁾ - see: Sec. 4.6.1. Although the U.S. experience is promising, the indications are that the potential for an effective relationship between the audit committee and internal audit can, with advantage, be developed much further.

2.5 Summary of matters to be explored

Present day theory of internal auditing reflects major progress in the audit scope or coverage of the organisation's activities and the level of service in individual areas (Chapter (1)). However, the preceding discussion of the problems of an expanded scope for internal auditing indicates that there are still dissenting views as to what it is that internal auditors should do, and should not do, within this broader role. Some are still questioning the basic justification for the internal

50 Chambers, A.D. and Snook, A.J., "1978 Survey of Audit Committees in the United Kingdom", Proceedings of the 4th Conference on Recent Developments in Internal Auditing (London: The City University Business School, May 1979), p.82.

51 The I.I.A. (7), op. cit., p.22.

auditor to extend his service activity to these broader total operational directions.

This brings us back to the general intention of this study which is to provide explanations indicating the nature of internal auditing when it is set up appropriately.

As a prerequisite, we need to identify and understand certain conceptual criteria which relate to the different types of internal auditing activities. These conceptual criteria are:

1. the functional areas actually to be reviewed,
2. the management levels at which the review is conducted,
and
3. the general features of the particular audit service.

2.5.1 To illustrate, the first criterion concerns the extent to which the internal auditor goes beyond the traditional accounting and financial control areas to other types of non-accounting and non-financial areas. Accounting/financial areas refer to the basic accounting and financial control activities and which would normally be attached to the finance function in an organisation. Non-accounting and non-financial areas refer to all of the other line and staff operations of the company that do not directly pertain to the basic accounting and financial control activities, and which would normally be the types of operations that are not under the direct supervision of the finance function in an organisation.

As was previously stated, the accounting and financial aspects of company operations were the original

concern of the internal auditor and continue to be a major area of interest. However, internal auditors are now extending their scope to embrace other operations outside the accounting and financial areas and it is no longer considered possible to separate accounting and financial aspects from other operational aspects.

Some of these non-financial areas are involved with basic control problems and have accounting/financial implications (for instance, they may be reflected in the management accounts): they have, therefore, been brought without too much difficulty into the sphere of internal auditing. Other non-financial areas, however, are more resistant to accepting the internal auditor's role. Here, a major test of the total effectiveness of the internal auditing service is the extent to which these other non-financial areas are actually reviewed and appraised by the internal auditor. These areas may not be control-oriented (e.g. marketing or R & D) or they may be very poorly accounted for in the management accounts (e.g. the personnel function, or the management development function).

Does the scope of internal auditing actually extend into non-financial areas? What types of non-financial reviews do internal audit departments (i) do in practice, (ii) consider they should do? What are the main factors which have an impact on the internal auditing effort in this respect?

The first research area in this study is very much concerned with seeking answers to these questions, (see: Sec. 2.6 see also Sec. 4.1 et seq).

2.5.2

The second criterion concerns the level in the organisation hierarchy to which the internal auditor is able to go in terms of the scope of his review and appraisal activity. Management levels are broadly viewed in this study as administrative-, executive-, and lower managerial levels, (see: Sec. (4) in Appendix (F)).

This point can be illustrated most clearly, perhaps, by looking at management - as pointed out in Appendix (F) - as controllers. According to this view, it is commonly understood that the control function in all business activities is not exercised by the internal auditor. Control is a function of line management, of the individuals who make decisions and those who are at the point of action with authorative powers to take and get action when needed. These individual controllers contribute in one way or another to the formulation of plans, policies, and objectives of the company.

This calls for an identification of the function of individual controllers either as policy-makers, planning-designers (i.e. administrative levels) and/or executives (i.e. executives and lower managerial levels). The internal auditor's relationship with each group will be largely determined in terms of demands and supplies of data passing to and from these groups in addition to his recommendations for improvement.

However, the problems of control which face each of these two managerial groups are different in nature and consequently the type of the internal audit service

needed differs (see: Sec. (5) in Appendix (F)). Executive and lower managerial levels are mainly responsible for the execution of plans as they have been designed by administrative levels; the task for the internal auditor in appraising the activities of executive and lower levels is relatively straightforward - to review for adherence to plan. This is in fact "compliance auditing". But it is not compliance of actual performance with a standard, plan, or policy which is most important, as this is a clerical procedure: it is the setting and application of policies, plans, and standards by higher management that matters most. The question which follows is to what extent is the internal auditor able to contribute to the higher levels? Here again the total effectiveness of the internal audit function is called into question.

Have internal auditors expanded their scope to include the activities of all management levels? How much do they work at each level? What is the nature of internal audit appraisal activity at each level?

The second research area in this study is mainly concerned to obtain answers to these questions, (see: Sec. 2.6 see also Sec. 5.1 et seq).

2.5.3 The third and final criterion, which relates to the general features of the audit activity, concerns the extent to which the audit service which is rendered (at both various functional areas and the different management levels) is viewed as either being narrowly protective or as being more widely constructive in nature.

Protective internal auditing refers to the maintenance of things as they are supposed to be in terms of existing policies, plans, and procedures. Constructive internal auditing is concerned both to evaluate and improve existing company practices, and may involve audit recommendations which are designed to lead to more efficient, effective or economic methods, rather than merely commenting on compliance with laid down procedures.

The narrow type of internal auditing will be largely directed to protective analysis and appraisal, often in relation to some set of dogmatic standards of financial control. Protective internal auditing, however, is important and must be provided for - yet the description of internal auditing as an "appraisal" activity suggests that the internal auditor is interested in and would give impetus to changes that would result in improvements in the way particular operational actions are carried out. As he is the specialist in the skills of independent review and appraisal with special expertise in the field of control, the internal auditor should work to cover the protective needs of the organisation and at the same time to give particular emphasis to the constructive potential of auditing.

The possibilities for constructive auditing are as broad as the range of business activity, but to what extent have internal auditors accepted these opportunities? What kinds of problems are there in practice and which might prevent internal auditors from doing constructive

audits?

The third research area in this study addresses itself to the probing for answers of these questions - see: Sec. 7.1.

2.6 Statement of research objective, areas, and hypotheses

Based on the foregoing discussion, the objective of research, research areas, and research hypotheses to be tested are stated as follows:

Objective of Research

Under the title of "the nature of internal auditing", the objective of this research is to investigate the management functions and the management levels at which internal auditing both attempts to, and succeeds in, providing a service, the nature of that service and to provide explanations.

Research Area No.1

Internal audit coverage by management function.

Research Hypothesis:

No.1.1: The scope of internal audit is changing to include non-financial aspects of the functional areas under review.

No.1.2: The extent to which non-financial aspects are audited is related to the line reporting relationships of internal auditing.

Research Area No.2

Internal audit coverage by management levels.

Research Hypothesis:

No.2.1: Most internal audit work is concerned with the activities of lower management.

No.2.2: Internal audit attempts to confine its appraisal activity to auditing the quality of management systems rather than to auditing the quality of management individuals themselves as (i) this is the nature of the accepted audit task, and (ii) this helps to avoid alienating internal audit from other management.

Research Area No.3

The nature of internal audit points made to management.

Research Hypothesis:

No.3.1: Most of internal audit's recommendations for systems changes which are designed to improve internal control are made by an analysis of historical happenings. While the recommendations for systems changes are designed to influence the future functioning of management systems, internal audit rarely appraises the forward planning systems of the organisation and thus misses a major opportunity to influence future events. Occasionally internal audit makes a post-project review of forward planning by comparing actual with budget (i.e. an audit of historical happenings) but it is almost unknown for internal audit to appraise future corporate plans.

No.3.2: Internal auditors are generally successful in making audit recommendations which:

(i) emphasise the basic protective aspects of the operations reviewed as well as contribute to the improvement of these operations.

(ii) help auditees to recognise their own problems and inefficiencies.

The preceding summary of matters to be explored can now set in the stage of the empirical framework of the study and its research methodology; this introduces us to the main topic of chapter (3).

CHAPTER 3

THE RESEARCH METHODOLOGY

3.1 Scope of the empirical study

Methods of obtaining information can be classified in many ways. In the social sciences - of which internal auditing is a branch - Sir C. Moser and Professor G. Kalton suggest that the following classifications as convenient:⁽¹⁾

- (a) Documentary sources,
- (b) Observation,
- (c) Mail questionnaire, and
- (d) Interviewing.

They added "While the above grouping is a useful classification, it should not be thought to imply that the methods cannot be combined. Indeed a combination of methods is often appropriate to make use of their different strengths."⁽²⁾

It was decided to adopt this approach in the collection of the information required for the purposes of this study. The thinking behind this decision was developed as follows. The "audit report" is an almost universal product of all internal audits and has been viewed as "the ever-important and logical conclusion to all audit work", "the visible end-product of an internal audit service", and "the culmination of all (audit) survey work and the major criterion of how well the job

1 Moser, C.A. and Kalton, G., "Survey Methods in Social Investigation", (London: Heinemann Educational Books Ltd., 1975), p.238.

2 Ibid., p.239.

has been done."⁽³⁾

Thus, so much importance is attached to this internal audit document and yet it is believed that it has not attracted any significant research interest. It provides an excellent source of documentary evidence of the nature of internal auditing. Accordingly, thought was given to the possibility of using *audit reports as the main source of information in this study.*

However, a report is a tool of communication. From this angle, the internal audit report is the medium by which the auditor's findings, recommendations, and general conclusion are conveyed to management. Therefore, the use in this study of internal audit reports alone, though an ideal research source, would not be good enough without considering in addition the views and attitudes of their producers (i.e. auditors) also those of their users (mainly other management members whose activities are liable to be subjected to internal audits - i.e. auditees).

Accordingly, consideration was also given to the possibility of constructing two mailed questionnaires which could be distributed to as many internal audit department managers and their auditees in the U.K. as was practical, supplemented by interviews with both of these two groups of informants.

3 Bigg, W.W. and Davies, J.O., op. cit., pp.173-180.

It was also considered useful, in addition, to use published data and findings in parallel areas to supplement the researcher's personal observations as additional research sources of information.

3.2 Organisation of the empirical study

The procedures taken in order to proceed with the chosen methods of collecting the information required, were carried out as follows:

1. The members' handbook of the I.I.A. (1975-1976) was used to identify the organisations which were likely to have internal audit departments. Membership of the I.I.A. was then restricted mainly to audit managers. Consequently, membership of the I.I.A. as well as a job in internal auditing suggested that the people involved were 'audit managers'. Within these boundaries, an internal audit manager is not necessarily the head of the internal audit department in the company but basically an auditor with supervisory functions over other internal auditors.
2. A letter inviting participation was sent in February 1976 to one member of each of the organisations represented in the U.K. Chapter, of which a copy is attached as part of Appendix (A).
3. A questionnaire was prepared and made ready to mail to audit managers who indicated their willingness to assist. Appendix (B) contains a copy of the Internal Audit Managers' Questionnaire.
4. A questionnaire was prepared and made ready to mail with each Internal Audit Managers' Questionnaire;

this questionnaire was to be directed to an executive manager outside the audit department and who had experienced an internal audit as an auditee.

Appendix (C) contains a copy of Questionnaire for Executive Managers.

5. After a period of three months, a preliminary evaluation of the response at that stage indicated a low initial response rate (9%) which would not be good enough to produce final results; however, the response was considered a fair response and adequate for the purpose of a preliminary experimental trial on a small scale at this stage of the research programme.
6. The conclusions drawn from this preliminary study (i.e. pilot survey) were examined in detail with respect to the main research areas of this study, and the research data were used to construct a more detailed analysis of information requirements. The results which emerged from this analysis were used and adopted as a basis for the investigation of internal audit reports. This investigation was based on a questionnaire specially designed for the purpose of (a) examining audit reports, and also (b) to cover some point mentioned in the responses and contained within the other completed questionnaires which it was considered appropriate to elaborate upon during interviews with audit managers and other management. Appendix (D) contains a copy of the Interview Schedule

used and a copy of Questionnaire for the Investigation of Internal Audit Reports.

7. The final stage of the empirical study was concerned with the analysis of information obtained and the interpretation and presentation of research findings and results. In this context, the information analysis was basically carried out on The City University's link with ULCC (London University Computing Centre), using SPSS - Statistical Package for the Social Sciences - version 6.52, 1977.
8. Table (3.1) shows an analysis of initial responses by numbers and percentage of audit managers participating in the study.

Table (3.1)

Analysis of Initial Responses by Number of
Audit Managers

	Number	%
1. Respondents requesting an Internal Audit Managers' Questionnaire only.	24	7
2. Respondents requesting both an Internal Audit Managers' Questionnaire and Questionnaire for Executive Managers	21	6
3. Respondents requesting both Questionnaires and allowing the researcher to examine their audit reports	6	2
Total replies	51	15*
4. Non-responses	285	85
Number of representatives from different organisations to whom the initial letter was sent.	336	100

* see: Sec. 3.5

Notes on Table (3.1)

Item (1): includes three questionnaires partly completed, and therefore they are excluded from the final analysis.

Item (2): all Executive Managers Questionnaires were returned fully completed (see Table (3.3)).

Item (3): it was considered from the outset that reviews of audit reports should be conducted in six organisation. This number of organisations was gained and the examination of audit reports was subsequently undertaken (see Table (3.5)).

Item (4): the main reasons for non-responses were: retired or retiring shortly (2), no longer employed as internal auditors (20), the audit department is new and not fully organised (10), and (253) not disclosed.

It is now appropriate to elaborate on each method of collecting the information.

3.3 Methods of Obtaining Research Data

3.3.1 Internal Audit Managers' Questionnaires

Because it was particularly designed to disclose some specific aspects of internal audit activities in relation to the main research areas of the study, it was considered necessary that this questionnaire should closely follow in its final form the research hypotheses stated under each research area (see: Sec.2.6).

The procedure for developing the questionnaires included giving the draft of each questionnaire to an

academician in the field of internal auditing and who happened to be a member and a governor of the I.I.A.; and who was also supervisor over this study. Afterwards, in a joint meeting with the researcher, each question was discussed in connection with related research area(s) and hypotheses and finally approved. Further copies of the draft questionnaire were also given to several academics and researchers in related areas - in The City University - who commented on the questionnaire. In the light of these discussions and comments the questionnaire was finally revised and prepared to be mailed.

Two follow-up letters were sent to every person who had not hitherto responded to the questionnaire. One of these two letters was prepared and directed by the supervisor over this study (see Appendix (A)).

Personal contacts during a specially arranged internal audit meeting attended by audit managers in The City University, May 1977 had gained some responses from audit managers who had hitherto been considered non-respondents.

Correspondence was maintained with individuals for clarifications of various queries. Table (3.2) shows a profile of organisations participating in this phase of the study.

Table (3.2)*

Profile of Organisations Participating in
Internal Audit Managers' Questionnaire

Categories	Industry & Commerce	Local Authorities	Public Utilities	Total
N. of Orgs. particip- ating	39 (81%)	6 (13%)	3 (6%)	48
Total N. of Employees	547430 (76%)	65350 (9%)	105570 (15%)	718350
N. of Internal Auditors	490 (65%)	179 (24%)	86 (11%)	755

N: Number.

Orgs: Organisations.

*See Q.2 & Q.4 in Appendix (B)

3.3.2 Questionnaire for Executive Managers

It was considered desirable that a questionnaire for executive managers should be completed by managers who had been on the receiving end of an internal audit. The main purpose of this questionnaire was to act as a 'control group' upon the responses to the internal audit managers' questionnaire, and also to facilitate the gathering of evidence of management reaction and attitude regarding internal audit activities.

The revision procedures followed in designing and preparing this questionnaire were similar to those followed in designing the internal audit managers' questionnaire.

It is important to note that executive managers who had agreed to participate in this questionnaire were selected by audit managers themselves as they were requested to do so (See Appendix (A)(1)). Possibly, one could infer that this sample could therefore have a more favourable view towards audit managers when compared with the average view of other managers. However, to overcome this possible bias, respondents were assured that all information received would be used only for research purposes with full confidentiality observed. They were also assured that people and organisations would remain anonymous in the final results of the study.

It is worth mentioning that at the time of this research programme, many organisations in this country had recently been bothered by several questionnaires from researchers in internal auditing and other areas. Therefore, there was no point in sending out a questionnaire directly to executive managers as it would have been badly received. Under these circumstances the procedure followed seemed to be the best possible way to obtain the requisite data.

Ultimately, all executive managers to whom the questionnaire was mailed, returned it duly completed.

Table (3.3) shows the classification of executive managers responded to this phase of the study in terms of the levels of management concerned as well as the types of area in which they served their organisations (i.e. financial areas and/or non-financial areas).

3.3.3 Investigation of Internal Audit Reports

As indicated earlier, this investigation was considered to be necessary for the purpose of testing the reliability of the information obtained from the respondents to whom the two questionnaires were mailed as well as to test the preliminary results which had emerged from the pilot survey; and to produce dependable inferences and final results which were basically built on *actual internal audit practices* as they could be deduced from the most important audit document - the internal audit report.

Table (3.3)

Classification of Managers Participating
in the Questionnaire for Executive Managers

Levels of Management*	Area of activity++		Total
	Number		
	Financial	Operational	
Administrative	2	3	5
Executives	2	13	15
Lower Managerial	1	-	-
	5	16	"21

* Levels of management are defined in Figure (1) (Appendix (F)).

++ Financial: Refers to managers in accounting/financial areas;

++ Operational: Refers to managers in non-accounting or non-financial areas.

" This number indicates the total number of Executive Managers who had been selected by Audit Managers as a 'control group' upon the completed Internal Audit Managers' Questionnaires, and which equals 44% of the total number of valid cases (i.e. 48 organisations) participating in the research (see: Table (3.1)).

According to the research plan, an in-depth analysis of internal audit reports produced by as many internal audit departments as practical was to be carried out by the researcher. Due to the confidential nature of the required information, it was from the beginning expected that this phase of the study might encounter certain difficulties which might affect the response rate.

Regardless of the fact that the process of obtaining data required for this particular phase of the study was very time-consuming one, in the end six organisations in this country allowed the researcher to see and examine copies of their audit reports in addition to many other audit documents. Moreover, two organisations mailed some of their audit reports and some other audit materials to be examined by the researcher on a strictly confidential basis.

In view of the confidential nature involved in this particular phase of the study, in addition to its novelty (i.e. until recently such investigation of audit reports had not been done in this country or anywhere in the world even on a small scale, as far as it is known), it seems safe to say that the response rate is fair and reasonable. As previously mentioned from the outset it was decided that a review of the audit reports of six organisations was the target to be aimed at. This number was seen as more than adequate for the purposes of the study and it would have been difficult to handle a larger sample than the approximately six hundred reports which were reviewed (Table (3.4)).

Table (3.4) shows the classification of internal audit reports examined, in addition to other audit material (see also Table (3.5)).

3.3.4 Interviews

Investigation of internal audit reports was combined and followed by in-depth interviews with the associated audit managers and other audit staff.

The main purpose of these interviews was to obtain a better, deeper understanding of audit managers' opinions and attitude towards the nature of internal auditing in general; to obtain more detailed information; and to expand on and clarify some points mentioned in their responses.

As a result of several visits made by the researcher to the audit departments concerned, twenty interviews, each lasts an average of two hours, were conducted with audit managers and other audit staff. Every audit manager was interviewed twice, once at the beginning and again at the end of each visit.

Interviewees were encouraged to express whatever opinions they cared to make upon their views of the audit function in their organisations.

Through this approach many issues were raised and discussed. Special emphasis was given to the more recent developments in internal auditing.

Responses and impressions were recorded first in brief notes, and afterwards (always on the same day as the discussion) in detail.

3.3.5 Personal Observations and Use of Published Data

Observations and use of published data and findings in parallel areas were also used as an aid to increase the reliability of data obtained, in addition to facilitate the gatherings of information which could be used for comparison.

Observations were carried out during meetings, seminars and conferences attended in most instances by audit managers. Responses and impressions were recorded after the discussions - immediately in most cases and after a short while in some other cases, but always on the same day.

On the other hand, thought was given to the possibility of using published data and findings in related areas as additional sources of research information covering certain areas of the investigation. The ways in which comparisons have been made to highlight a particular result will be mentioned in this study whenever appropriate. All references are provided in the Bibliography filed at the end of this thesis.

Table (3.4)

Description of Audit Material Provided by
The Internal Audit Departments

Description	Number
1. Internal Audit Reports*	562
2. Correspondence between auditors and auditees before and after the audits.	300
3. Copies of the management Policy Statement of audit function	20
4. Audit Programmes of work to be done in each audit	6
5. Rights of access and reporting structure of internal audit	6
6. Organisation Charts	6

* For more detailed description of this item see Table (3.5).

Notes on Table (3.4)

- Item (1): see Table (3.5).
- Item (2): Enormous amounts of audit correspondence were available for the purpose of the examinations; however, a sample of (50) was selected as adequately representative of this item in each organisation visited by the researcher.
- Item (3): In addition to the six organisations visited, 14 organisations mailed copies of this item to the researcher; and some other organisations preferred to point out the broad lines under which their policy statements were governed. Question No.5 in the Internal Audit Managers' Questionnaire was designed to cover this ground (see Appendix (B)).
- Item (6): Audit managers were asked to provide the researcher with up-to-date organisation charts showing the overall structure and management of the internal audit department concerned as well as the areas audited, and the duties, lines of responsibility and accountability of their key personnel. This was available in only two organisations. Nevertheless, with the assistance of the audit manager in charge, organisation charts supplemented by brief notes illustrating the information required were prepared and used for the purpose of this study with respect to the other four organisations

visited. Question No.2 under Section (1) in
the Investigation of Internal Audit Reports
was designed to cover this ground
(see Appendix (D)).

Table (3.5)

Classification of Internal Audit Reports Provided By
The Internal Audit Departments

Type of Reports	Formal Reports					Informal Reports					T o t a l
	Year of Issue										
	1973	1974	1975	1976	1977	1973	1974	1975	1976	1977	
Reports of Accomplishment	4	2	6	5	3	-	-	-	-	-	20
Reports on the Firm's Activity											
= Final Audit Reports	16	21	138	158	30	-	-	-	-	-	363
= Summary Reports	-	12	66	70	-	-	-	-	-	-	148
= Progress Audit Reports	-	-	-	-	-	-	2	8	6	9	25
Special Audit Reports	-	1	2	3	-	-	-	-	-	-	6
All Reports (Total)	20	36	212	236	33	-	2	8	6	9	562

Notes on Table (3.5)

1. *Reports of Accomplishment*: refer to periodical audit reports prepared by the senior members of the internal audit department which summarise the main audit findings and recommendations for the period under consideration, and which afford a concise review of the department's activities for that period (often annually and sometimes each six months). This kind of audit report is usually submitted to the management official who is responsible organisationally for the audit department within the organisation.

2. *Reports on the Firm's activities*: this classification indicates internal audit reports which are prepared by the audit staff on the results of their audits or reviews of each audited area.

It has been found that this kind of audit report comes in many shapes and sizes depending much upon the internal audit reporting practice being followed in each organisation. However, the common ground is that an audit report is issued after each audit, and this has been classified as a *formal, final audit report* - usually addressed to the manager of the audited area.

Internal audit reporting practice in most organisations visited (and in other organisations participating in the I.A.M.Q., (see Question No.19 Appendix (B))) disclosed another kind of audit report which was basically an audit report on the organisation's

activities but limited to the most significant audit findings and prepared to be communicated periodically to senior executives (i.e. to management above the level of the audited areas). This kind of audit report has been classified as *Summary Reports*.

When matters require the prompt attention of management concerned or for any other purposes warrant immediate reporting, some audit departments issue interim audit reports covering such matters, and these have been classified as a *progress, informal audit report*.

3. *Special Audit Reports*: this classification refers to audit reports on the results of special investigations and enquiries - that is audit researches based on special management requests.
4. Audit managers were asked (Question No.25 I.A.M.Q., see Appendix (B)) whether they would be prepared to let the researcher see and examine their audit reports for the past five years (back from 1976). This was intended to expose any indications of trends in internal audit scope and practice over the last few years - see: Sec.4.1.2.

Some of those who agreed indicated that the reports were available only for three years. Other audit managers indicated that the reports were available for less than three years (i.e. newly established audit departments). However, with their agreement, the researcher came back at later date (early 1977) and

reconducted the investigation required. In the end, the picture was as it is presented in Table (3.5).

3.4 Characteristics of the Responses

Having outlined a detailed description of the procedures taken in carrying out the chosen means of investigation, it is now appropriate to indicate some features concerning the responses obtained in each source of information used with regard to its validity to the purpose of the study.

1. Internal Audit Managers' Questionnaire

The purpose of this questionnaire was to allow the gathering of information concerning internal audit practice as perceived by internal auditors.

Information was gathered from organisations which on the basis of their number of employees were on the whole large organisations in different fields of industry.

The questionnaire thus provided data which allowed the study of internal auditing in line with what happens in actual practice, in different environments, and as viewed by the people who are doing the job in the field of internal audit.

Table (3.6) shows the number and classification of the organisations participating in this phase of the study in terms of size and type of corporate activity.

An analysis of the job titles and backgrounds of the heads of internal audit departments participating in this phase of the study reveals that the information obtained reflects the views of auditors at the

Table (3.6)*

Number and Classification of Organisations
Participating in Internal Audit Managers'
Questionnaire

Type of Activity	Size					Total
	'by thousands of employees'					
	under 1	1-5	5-10	10-50	50-100	
● <u>Industry & Commerce</u>						
(Building Societies & Construction & Allied industries)	1	1	1	2	-	5
(Electrical, Radio & Engineering industries)	-	-	3	3	-	6
(Manufacturing - General)	-	-	2	5	1	8
(Motor Trade)	-	-	1	1	-	2
(Food manufacturing and distribution)	-	-	2	2	1	5
(Banking, financial services, insurance)	3	4	1	2	-	10
(Other commercial)	-	-	1	2	-	3
● <u>Local Authorities</u>	1	2	1	2	-	6
● <u>Public Utilities</u>	1	-	1	-	1	3
All Organisations Total	6	7	13	19	3	48

* See Q.2 in Appendix (B).

higher levels of seniority in their departments - an indication of the validity of information gathered and used. The results of this analysis are shown in Table (3.7).

2. Questionnaire for Executive Managers

As indicated earlier, this questionnaire was designed not only to disclose other manager's perceptions and attitudes towards the internal auditor's work but also to act as a "control group" upon the Internal Audit Managers' Questionnaire.

Table (3.3) shows that participants in this phase of the study were in positions which covered all management levels - specially those at executive and administrative levels - and were also in both the financial and the non-financial areas in the company. Table (3.8) indicates that managers who responded to this questionnaire had moderate to extensive first-hand contact with internal auditors in their organisations, and this could be statistically accepted with 95 per cent confidence.

Another clear indication that respondents to this questionnaire had a high degree of familiarity with the work of internal auditors in their organisations is revealed by the fact that all of them stated that they had knowledge of the content of audit reports at different times but in most cases before the final report goes to higher levels after the audit. An analysis of their responses to the question on which this result is based is given in Table (3.9).

Table (3.7)*

Job Titles and Backgrounds of the Heads of
Internal Audit Departments Participating
in the Study

Job Titles	Backgrounds		Total
	Financial	Non-financial	
Director/Audit Division	3	-	3
Chief Internal Auditor	9	3	12
Group Internal Auditor	14	-	14
Head of Internal Audit Department	2	-	2
Chief Operational Auditor	1	-	1
Group Management Auditor	1	-	1
Management Audit Controller	-	-	1
Principal Assistant, Financial Services	1	-	1
Computer Systems Auditor	1	-	1
Administrative Assistant (A.C.I.S.)	-	1	1
Internal Audit Officer	-	1	1
Security Manager	-	1	1
	42 (87.5%)	6 (12.5%)	48 100%

* See Q.3 in Appendix (B).

Table (3.8)*

Executive Managers' Contact with Internal Auditors

Scale		NVC	%
3	Extensive	8	38.1
2	Moderate	11	52.4
1	Little	2	9.5
		21	100
Mean: 2.29 S.D.:.64 .95 C.I. 2.0 To 2.58			

Table (3.9)**

Timing of Communicating Audit Results to other Management

How do you obtain information of internal audit findings and recommendations?	YES		NO	
	NVC	%	NVC	%
	• during the audit	20	95	1
• at the end of the audit	19	91	2	10
• from report drafts	17	81	4	19
• from final reports	15	71	6	30
• after the audit	8	38	13	62

NVC: number of valid cases "answers"

* See Q.3(b) in Appendix (C)

** See Q.5 in Appendix (C), see also Table (7.14)

3. Investigation of Internal Audit Reports

Data and information obtained through this investigation were mainly deduced from audit reports of a wide variety which were produced by the audit departments in different organisations belonging to different fields of industry. This made it possible to take a closer look at current practices of internal auditing and thus added significant support to the other means of investigation used in this study.

This investigation also included reviews of other audit material which allowed the researcher to check upon the accuracy of individual answers in the two questionnaires and also to follow-up some specific aspects relevant to certain research areas and hypotheses. Discussions during interviews with audit managers and other audit staff in the organisations visited, provided any clarification needed.

It is important to note that some of the information obtained and used in this data analysis was based upon direct information and comments provided by the audit managers in the light of their current experience or as they used to carry out their activities rather than deduced from audit documents. In these cases any ways in which this data is limited in the use to which it can be put will be mentioned in its proper place in the discussion of research findings, whenever necessary.

3.5 Sources of research data in perspective

I.R. Parket pointed out that:

"By a 'representative sample' we mean that the sample should have the same characteristics as the population under study."(4)

Bearing this in mind, the process of internal auditing when reduced to its barest essentials, is largely an auditor, an auditee, and an audit report that integrates the effort of the former in connection with the activities of the latter to achieve better results for the benefit of the organisation they serve.

Methods of obtaining the information followed in this study have covered these three important sources of research data. First, internal auditors participating in the study are at the higher levels of seniority in their organisations and, secondly, other management participants are from differing managerial levels and differing functional areas, and have a high degree of familiarity with the work of internal auditors in their organisations. These organisations are from different fields of industry. It is, therefore, considered that the sample chosen from each of these sources is representative for the purposes of our study. Yet, despite the research sample being considered representative, there will always be the risk of errors arising due to the sampling and questionnaire techniques themselves. These problems underlie many of

4 Parket, I.R., "Statistics for Business Decision Making", New York: Random House, Inc., 1974), pp.62-63.

the prevalent problems in social research and their treatment is thoroughly discussed in specialised texts.⁽⁵⁾

What concerns us here, however, is the issue of the reliability and validity of information obtained and the conclusions which can be drawn therefrom.

In this context,

"Reliability refers to consistency to obtaining the same results again. Validity tells us whether the question or item really measures what it is supposed to measure."⁽⁶⁾

In this sense, it is possible to have a measure that is highly reliable (i.e. consistent) yet of poor validity. But if the measure is valid, then it must also be reliable.

Accordingly, since all sample results are subject to sampling errors, it is necessary to accompany any sample result with a statement about its precision. In individual cases, this statement is made in terms of what is called a 'standard error' which is a suitable measure of the variability of the various sample estimates - that is of the probable accuracy or precision of any one estimate.

In some situations the purpose may be to test a statistical hypothesis about the population under study. Here the question that needs to be answered is often whether the sample result is such as to discredit the

5 See for example:
Kahn, R.L. and Cannel, C.F., "The Dynamics of Interviewing",
(New York: Wiley, 1957), esp. Chapter (5).

6 Oppenheim, A.N., "Questionnaire Design and Attitude Measurement",
(London, Heinemann Educational Books Ltd., 1973), p.69

hypothesis or whether it lends support to it. To answer this question, one needs a criterion by which the deviation of the sample result from the hypothetical value can be judged; this criterion again is found in the measure of precision mentioned in the previous paragraph. However, another question arises as to how much confidence we can have when estimating the population value from a sample value. The answer to this question lies in what is called "confidence interval", which consists of an upper confidence limit and a lower confidence limit, and we assign a probability statement to the effect that this interval contains the true population value. The different probabilities which may be associated with confidence intervals are called 'confidence levels' of which 95 per cent level is often used.

These statistical techniques have been used throughout in arriving at the results of this study; the research findings, therefore, have to be viewed in accordance with the level of confidence attached to each result obtained and shown in the individual tables contained in this study.

In conclusion, it is considered that the research data is statistically reliable and that results can be drawn therefrom with a reasonable degree of statistical validity.

3.6 The plan of analysis

The main research areas and the research hypotheses were outlined at the end of chapter (2). The interrelations between these research areas and hypotheses

in connection with sources of empirical research were structured according to the following steps:-

1. Each research area has been divided into a set of basic hypotheses as illustrated in chapter (2).
2. Since the questionnaires used were designed in line with research areas and hypotheses, consideration was given to the possibility of using some of the questions included to serve more than one research area and/or hypothesis. Therefore, all questions in each questionnaire were converted to a set of variables and linked with their related research area(s) and hypotheses. In this way it was possible to proceed with the statistical analysis of the data and information obtained.
3. A comprehensive picture of these procedures is provided in Appendix (E).

CHAPTER 4

INTERNAL AUDIT COVERAGE BY MANAGEMENT FUNCTION

Internal auditors - the literature would suggests - have recently expanded their scope to a review of controls within operational areas outside accounting and finance (see: Sec. 1.5).

It is also asserted that operational audits are now given, at least in theory, even more emphasis than the audit of accounting and financial matters and that it is no longer considered possible to divorce accounting and financial auditing from operational auditing.⁽¹⁾

As indicated in Chapter (2), the first research area in this study is identified as dealing with internal audit's involvement in auditing non-financial 'operational' areas.

It is the purpose of this chapter to seek empirical answers to the following two questions:

1. Does the scope of internal auditing actually extend into non-financial operational areas?
2. What are the factors which have a bearing upon the effective functioning of internal auditing in this respect?

1 Chambers, A.D. (3), op. cit., p.95

Recent developments in internal auditing suggest that internal auditors are now attempting to adopt a broader and more management-oriented approach. One major evidence of this is the development of internal audit scope and practice into a concern for a review of non-financial operations (see: Sec. 1.5).

'Operational areas' are defined in this study as all line and staff operations of the concern where the fundamental activity does not directly pertain to the basic accounting and financial control activities. These would normally be the types of operations that are not under the direct jurisdiction of the finance function within the company.

This progressive view of internal auditing implies that the scope of operational auditing includes "all operations" including the accounting and financial aspects of areas under review instead of being limited to merely the accounting and financial matters in which traditionally the internal auditor may have directed his attention - e.g. to such matters as the recording of sales, the entries of inventories and cost of sales, the handling of accounts receivable or accounts payable, and the like.

Accordingly, an internal audit which is restricted to a review of basic control problems and related accounting and financial implications within the operational areas which are otherwise fundamentally outside the accounting and finance functions is not viewed in this study as a full audit of non-financial areas. This is a straightforward internal audit of the

accounting and financial aspects of operational areas, though they are outside accounting and finance. For example an audit of production which reviewed the management accounts alone would not be regarded as a full operational audit; but an audit of production which entailed the auditor observing the process of setting up a machine in order to review the efficiency of this process would be classified as an operational audit as the data which is reviewed includes non-accounting and non-financial data.

The following discussion and analysis of the research findings has been developed and interpreted based on this distinction between financial and operational audits.

Plan of empirical investigation

As a starting point in the study of this research area, the following hypothesis was constructed:

"The scope of internal auditing is changing to include non-financial audit areas".

The examination of the validity of this hypothesis may be approached from differing angles. In this study the following investigations were carried out to achieve this purpose:

1. Analysis of the topics of audit reports produced by the internal audit departments in the organisations participating in this phase of the study (see: Sec. 3.3).
2. Analysis of the use of internal audit staff time of the same organisations.

3. Analysis of the nature of internal audits performed in operational areas.
4. Analysis of other management's views concerning internal audit effort in this respect.

4.1 (1) Investigation of audit reports

Through an investigation of the topics of the 363 final internal audit reports produced by the audit departments responding to this phase of the study (see: Sec. 3.3.3), an in-depth analysis of internal audit recommendations made was carried out to:

- (i) determine the proportion of internal audit effort spent on non-financial audits in comparison with that spent on financial audits within the operations under review,
- (ii) detect any trends in internal audit scope and practice over the last few years (five years, 1973-1977), and
- (iii) determine which operations are found to be most amenable to audit.

4.1.1 Analysis of internal audit effort

A primary presentation of this investigation is shown in Table (4.1). In general, data in Table (4.1) shows that on average four-fifths of the total number of audit points made were based on financial internal audit work within the operations under review, compared with only one-fifth for non-financial audit work. At first sight it would seem that most of internal audit effort is still directed to the review of the financial aspects of the areas under review.

Table (4.1)

Analysis of Internal Audit Points by
Year and Audit Phase

Year of issue	Number of reports	Number & proportion of audit points			
		Audit Phase			
		Financial Aspects		Non-financial Aspects	
		Number	%	Number	%
1973	16	119	100	-	-
1974	21	136	85	24	15
1975	138	669	81	152	19
1976	158	946	78	284	22
1977	30	164	79	44	21
Total	363	2034	80	504	20

However, the individual ratios attached to each year under non-financial aspects do suggest an increasing tendency towards developing the scope of internal auditing into a concern for reviewing the non-financial aspects of the areas under review.

A more explicit way to detect the general trend in the scope and practice of internal auditing can be revealed by using the chi-square test of independence to investigate the relationship between internal audit effort spent on both financial and non-financial aspects of the areas under review over the five years under study.

The hypothesis and procedures for carrying out this test were as follows:

Null hypothesis: the time factor (i.e. the year in which the audit work was done) has no effect on the extent to which internal auditors have been engaged in non-financial audit work.

Presentation: the calculation of chi-square test of independence are usually presented in what is called a "bivariate frequency table" and the statistical test is made to determine whether classification on the row variable is independent of the classification on the column variable. With reference to this investigation, Table (4.2) is a 2 x 3 bivariate table in which the row variable was used to classify the audit points observed by phase (i.e. financial aspects versus non-financial aspects) and the column variable to classify the audit points observed by

Table (4.2)

Analysis of Internal Audit Points by
year and Audit Phase

Categories Year Audit Phase	1973/74		1975		1976/77		Totals
	Financial Aspects	224	255	658	669	1152	
		12%		33%		55%	
Non-financial Aspects	55	24	163	152	286	328	504
		5%		30%		65%	
Totals	279		821		1438		2538
Chi-square value at .01 level of significance					calculated	tabled	
					30.1	9.21	

years. Due to the restriction of having a smaller number of audit reports in 1973 and 1977, it was considered a necessary procedure to combine 1973 and 1974 into a single category and the same procedure was followed as to 1976 and 1977.

On Table (4.2), the figures placed in the main part of each cell represent the observed frequencies of audit points under each category (i.e. the actual number of audit recommendations made) and the figures placed in the small boxes in the lower right corners in each cell represent the ratios of these observed frequencies as percentages.

The figures placed in the small boxes in the upper left corners of the cells shown in Table (4.2) indicate the expected frequencies of audit points. These are theoretical relative frequencies of the subjects under study which are in this case audit recommendations. For illustration, the expected frequency in the first cell is calculated as follows: The sum of audit points in the first row X The sum of audit points in the first column and the result is divided by the total number of audit points in all category - that is $(279 \times 2034) \div (2538) = 224$.

Significance level: at a predetermined level of significance the calculated chi-square should be compared with the tabled value having (row - 1) (column - 1) degrees of freedom. Here, at the ".01 level of significance" is used with $(2-1) \times (3-1) = 2$

degrees of freedom. Under these conditions, the tabled value of chi-square equals 9.21.

Decision: If the calculated value of chi-square equals or exceeds the tabled value, the null hypothesis is rejected, the row and column variables are determined to be dependent at the specified level of significance.

As shown in Table (4.2) the calculated chi-square equals 30.1 which exceeds the tabled value 9.21. Consequently, the finding is significant and the hypothesis of independence is rejected. *There is a significant relationship between the time factor and the extent to which internal auditors are engaged in non-financial audit work.*

4.1.2 Trends in the scope of internal auditing

The importance of the above result lies in the fact that the size of the calculated value of chi-square reflects the magnitude of the discrepancy between the observed audit points and the expected audit points in each cell in Table (4.2) and the comparison between them reflects the direction of any trends in internal audit scope and practice over the five years under study.

Looking first at the financial category, the comparison between the expected and observed values in 1973-74 and 1975 indicates that observed actual audit points made exceed the expected audit points in these two periods.

An opposite trend can be recognised in the same two periods regarding non-financial category where expected

audit points exceed the observed actual audit points made. It would appear therefore that internal audit efforts were more directed to the review of the financial aspects of the operations under review over these two early periods.

It seems, however, that the trend has been to move relatively away from this type of financial audit and to be concerned with audits of the non-financial aspects of the areas under review. This can be recognised from the comparison between the expected and observed values of audit points in 1976/77 where actual financial audit points made were less than expected and actual non-financial audit points made were more than expected. The proportions of audit points made in relation to both financial and non-financial categories suggest the same interpretation.

Yet, this does not necessarily mean that either internal audit effort or effectiveness in reviewing the financial aspects of the operations audited has decreased, but rather the scope of audit coverage and the type of emphasis has shifted to include more non-financial aspects of the operations within audit's purview.

4.1.3 The functions most amenable to internal audits

Based upon the researcher's observations during examining audit reports and relevant audit materials (i.e. audit programmes of work to be done in each audit, correspondence between auditors and auditees before and after audits, audit policy statements), the operations most frequently subjected to internal audits were identified as follows (see Q.1 (iv) and (v) in Questionnaire for audit reports' investigation - Appendix (D)):

- Stock control (Moderate),
- Purchasing - disposal of scrap and material control (Extensive),
- Production - scheduling and control, production planning, and machine loading (Moderate),
- Safety, security and insurance - specially in banking industry (Extensive),
- E.D.P. - restructuring of E.D.P. systems (Moderate to Extensive),
- Quality control - rejection procedures and control, repairs (Little), and
- Personnel (Moderate).

In most instances, internal audit work in these areas is based on the selection of an activity or process for review and appraisal (i.e. functional audit style - see: Sec. 6.2).

For example, a review of the purchasing function could include examining the procedures from the time a department decides that it needs a particular article or commodity, through the purchasing process right up to the procedures for payment and charging to expenses in the accounts. It could also include an audit of purchasing operations regarding the factors required for efficient purchasing, co-ordination with other departments, control policy over the purchasing function, authorisation for purchase, selection of the right supplier, negotiation of price and settlement terms, issuance and follow-up of the order, receipt and inspection of goods, authorisation of payment, operation of stores, sale of scrap.

In more general terms, internal audit work done in operational areas mainly consists of an appraisal of controls as specified by the procedures relating to methods of operation and the safeguarding of assets. This also includes a detection of possible sources of waste and a feedback of information on the cost efficiency of the work done and the extent of compliance with laid down operational policies and procedures, and extent of adherence to operational plans.

This indicates a departure from merely auditing the accounting and financial aspects of the operations under review into auditing of non-financial implications related to operational areas as well.

More evidence on this shift of emphasis in internal audit work is revealed through the following analysis of the use of internal audit staff time of the same organisations responding to this phase of the study.

4.2 (2) Analysis of the use of audit staff time

Q.3 in the Questionnaire for the Investigation of Audit Reports (Appendix (D)) was designed to glean information concerning the use of internal audit staff time in connection with the following internal audit activities:

- (i) Audit work:
 - (a) involvement with internal control reviews - financial aspects,
 - (b) involvement with internal control reviews - non-financial aspects.

(ii) Non-audit work:

That is work which is a necessary part of the accounting system and/or the internal check system employed in the organisation. This is when the auditor may be required to act not as a reviewer of control or check procedures but as the person who actually conducts the control or check.

From the standpoint of this study, which is also in line with generally accepted statements of relevant auditing theory and practice, the operation of routine controls and checks, does not constitute internal audit work even when carried out by persons who undertake other duties which can properly be so described.

Due to the fact that there was only one audit department among those which agreed to participate in this phase of the study which followed the practice of keeping time records showing the use of internal audit staff time, the following analysis has had to be based mainly upon data obtained from audit managers in the organisations concerned.

Bearing this in mind, the use of internal audit staff time in these organisations was determined as follows:

%

(i) Audit work:

(a) Internal control reviews -

financial aspects

55

	%
(b) Internal control reviews -	
non-financial aspects	32.5
(ii) Non-audit work:	
Involvement with internal	
check	12.5

These ratios - average of personal estimations provided by audit managers - add further evidence which indicates an expansion in the scope of audit work to a review of controls in operational areas outside accounting and finance. 32.5% of the use of their audit time is said to be spent on internal control reviews which have a requirement to audit non-financial aspects of the operations under review, whereas, traditionally internal auditing consisted of reviews covering only the accounting and financial areas. However, this does not alter the fact that more than half of the internal audit time used is spent on audits concerned with the accounting and financial aspects of the operations audited.

Although internal audit scope is changing to include non-financial audit areas, some 12.5% of internal audit staff time in the organisations concerned is spent on internal check activities. When internal auditors perform their audit as reviewers of employed systems only then they are performing true audit work; their involvement in any type of work which constitutes an integral part of the basic systems jeopardises their independence.

Unfortunately the internal check activities which are given to internal audit to do, are usually those which top management regard as the most important ones. Since internal audit is given the task of performing these internal check activities, it follows that they are in a poor position to perform audits of these most important internal checks - if they were to do so they would be auditing their own work. Thus the most important internal check measures are in danger of being deprived of effective internal audit.

When internal auditing becomes involved in current routine checks or other routine accounting works, there is a great possibility that accounting staff tend to lean on the audit personnel and, hence, the true function of auditing which can only operate properly after the completion of accounting, is lost.

Nevertheless, it seems that internal auditors are trying to steer clear of such involvement with internal check and routine activities as the following memorandum written by the audit manager in one of the organisations visited indicates:

"From: ... Audit Manager
To : ... Manager in charge of Foreign Exchange Operations

As you may be aware, there have, in the past, been adverse comments concerning the Audit Department participation in the preparation of the monthly profit/loss calculations in respect of Foreign Exchange.

... ..

It is the opinion of the Audit that none of the above work should be carried out by the Audit Department. We should only check the figures after the event."

In conformity with the above analysis and discussion it appears reasonable to conclude that the scope of internal auditing is turning away from strict financial auditing and the emphasis has shifted to one which also embraces a review of controls in operational areas outside accounting and finance. This undoubtedly confirms an extension of internal auditing into operational auditing.

Other research obtained similar results. The I.I.A. survey of internal auditing, 1975 came to the conclusion that "No longer does there appear to be a preponderance of emphasis on financial audits. Operational audits are now receiving about the same amount of emphasis."⁽²⁾

This study was based on a questionnaire only and the responses were not analysed in a statistically valid way. The conclusion was obtained from a question in which the respondents were asked to indicate what percentage of their audit efforts is spent on financial and operational audits, and the answers received showed that an equal amount of audit effort is expended on both financial and non-financial (operational) audits. Also, the same survey indicated that the scope of activities reviewed in certain non-financial areas increased markedly in comparison with the results of the 1968 survey also prepared by the I.I.A. These areas, as shown in Table (4.3) are: Electronic Data Processing, Management Information Systems, and Organisational Control.

Other areas showing less activity were: Inventory Planning and Control, Insurance Programmes, Purchasing and Traffic - see Table (4.3).

2 The I.I.A. (7), op. cit., p.9.

Table (4.3)

Functional Areas Subjected to Internal Audits
(USA and other International)

Activities or Functions audited	1975	1968
	%	%
Advertising	48	47
Construction Projects	56	56
E.D.P.	79	64
Inventory Planning and Control	67	80
Insurance Programmes	60	66
Management Information Systems	60	48
Organisational Control	63	44
Production	53	46
Purchasing	84	89
Traffic	47	51
Other	41	-
Sample Size	343	308

4.3 (3) The nature of audits performed in operational areas

The actual role of the internal auditor in operational auditing can perhaps be said to be at one or more of three different levels. At the most elementary level there is the concern for the more financially-oriented *protective role*. At the second level the internal auditor is concerned with ascertaining the extent of *compliance* with established policies, plans, and procedures as they affect the efficiency of the various administrative operations and controls - financial or otherwise. At the third and most advanced level the role of the auditor is to look for new approaches that hold varying degrees of promise for achieving more *efficient* and more *effective* operational performance.

The internal auditor has his clearest acceptance at

the first level, and to a certain extent he would not be questioned or challenged by operating officials when working on any sort of compliance activities. But his evaluation of the overall performance of operating departments from the standpoint of efficiency and effectiveness would be more likely to be challenged.

As reported earlier in this chapter, the scope of internal auditing is changing to include operational audit areas. It is now appropriate to investigate the nature of internal audits performed in these operational areas, and since the internal auditor's role in evaluating basic controls and related financial aspects of the operational areas is not seriously challenged, the following analysis is very much concerned with the internal auditor's role at the second two levels referred to above.

A set of five audit activities were identified so as to represent the most likely aspects that would be subjected to an internal audit which evaluated overall performance of operating departments within an organisation.

These activities include the following aspects of operating performance:-

- (i) plan of organisation,
- (ii) policies in effect,
- (iii) procedures being followed.

(The above three aspects represent the main areas of audit work involved in a review of compliance).

- (iv) results being achieved

(v) individual performance

(These two aspects represent the main areas of audit work concerning efficient and effective functioning of operating departments in an organisation).

4.3.1 Audit managers were asked (Q.10(v) - Appendix (B)) to indicate which of these audit activities were done by the internal audit department in their organisations. If the answer was "YES", the respondent was requested to refer the degree of audit's involvement in evaluating the particular audit activity. Table (4.4) summarises their responses to this question.

Table (4.4)

Internal Audit's Involvement in Evaluating
Operating Performance

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
	YES			
3	Extensive	23	48	48
2	Moderate	11	23	71
1	Little	6	12.5	83.5
0	NO & N/A	8	16.5	100.0
		48	100.0	
Mean:2.0	S.D.:1.14	.95 C.I.	1.68 to 2.32	

Based on the data in Table (4.4), 83.5% of the audit departments responding reported that they are involved at least to some extent in evaluating overall performance of various operating departments of their organisations. This is done extensively in 48% of cases, and moderate

involvement is reported in 23% of cases, whereas 12.5% of audit departments indicated little involvement.

As against this, 16.5% of the respondents answered negatively of which 12.5% stated that they are not involved in audits of operating departments and 4% indicated that this was not applicable.

However, merely accepting "yes" or "no" type of answers may result in a misleading interpretation. To avoid the risk of this, a confidence interval at .95 level of confidence (usually referred to as (.95 C.I.)) was constructed to estimate the average of the population (i.e. internal auditors) response from sample data (i.e. answers provided by audit managers).

As Table (4.4) shows, the calculated .95 C.I. indicates a 1.68 to 2.32 confidence interval for the average of the population response on the 3-point scale used. This evidence suggests that internal audit's involvement with the evaluation of operating performance is ranging from a *little* to slightly over a *moderate* degree of involvement.

4.3.2 Further analysis of the answers received according to the nature of audits performed (i.e. compliance versus efficiency and effectiveness audits) and the degree of internal audit's involvement in each type of audit is presented in Table (4.5).

Data in Table (4.5) show that internal audit effort seems to be more directed towards the review of compliance (62%) rather than reviewing and appraising performance aspects related to operating efficiency and effectiveness (38%).

This is further supported by the calculation of .95 C.I. which indicates a 2.0 to 2.36 confidence interval for involvement with compliance activities and a 1.54 to 2.0 confidence interval for involvement with reviews of efficiency and effectiveness. This evidence suggests that compliance audits are given more emphasis than are reviews of efficiency and effectiveness.

It is interesting, however, to go further and to examine the breakdown of the ratios shown in Table (4.5) by individual item as indicated in Table (4.6). The cumulative percentages of those who stated affirmative answers are tight, but it can be recognised that compliance with laid down procedures is given the highest percentage (91.7%) - see item (3) in Table (4.6).

For a more convincing comparison, a confidence interval at .95 level of confidence is constructed for each item in Table (4.6), and based on the results obtained it appears that internal auditors are *extensively* involved in ascertaining the extent of compliance with established operational procedures.

Compliance with operational policies and related plans of organisation is given less emphasis with a degree of involvement ranging from *little* to *moderate* involvement.

On the other hand, evaluating operational results seems to have a relatively higher degree of auditors' emphasis than any other item in Table (4.6) with the exception of compliance with established procedures. As shown in Table (4.6) the extent to which operational

Table (4.5)

Ratio Analysis of Total Internal Audit Effort in
Evaluating Operating Performance in Terms of
Audit Activities being Performed

S c a l e	Degree of Internal Audit's Involvement	Audit Activities Performed		T o t a l
		Compliance	Efficiency and Effectiveness	
		%	%	%
	<u>YES:</u>			
3	Extensive	34.0	14.0	48.0
2	Moderate	11.6	11.4	23.0
1	Little	5.9	6.6	12.5
	Sub-totals	<u>51.5</u>	<u>32.0</u>	<u>83.5</u>
	Adjusted ratios	(62)	(38)	(100)
0	<u>NO & N/A</u>	<u>8.2</u>	<u>8.3</u>	<u>16.5</u>
	All Total	59.7	40.3	100.0
<u>Statistical Measures:</u>				
	Mean	S.D.	.95 C.I.	
	Compliance	2.18	1.10	2.0 TO 2.36
	Efficiency and Effectiveness	1.77	1.14	1.54 TO 2.0

results are evaluated by internal auditors is ranging from 1.85 to 2.46 on the 3-point scale used which suggests *a more than moderate but less than extensive* involvement. It appears, however, that internal auditors place less emphasis on evaluating individual performance within the operational areas. Table (4.6) shows that their involvement in the evaluation of operating personnel ranges from 1.22 to 1.87 on the 3-point scale used which indicates only a small degree of involvement. This is in line with the generally accepted audit task (see: Sec. 6.1 et seq).

Findings shown in Table (4.5) may be compared with the results of other research made in the U.S.A. in 1976.⁽³⁾ In this study a two dimensional scheme for classifying internal audit activities was introduced to the respondents. They were asked to enter the percentage of internal audit activity in the appropriate boxes in the constructed scheme. Responses to this question are presented here in Table (4.7).

Table (4.7) indicates that most (70.17%) of audit activity is concerned with compliance activities of which 26.97% is based on non-financial audit data. However, some 29.83% of total audit effort did belong to reviews of efficiency and effectiveness of which 17.21% based on non-financial audit data. The study further indicated that the level of extended internal audit

3 San Miguel, J.G. et al, op.cit., pp.5-11.

Table (4.6)

Nature of Internal Audit Activities
Performed in Operational Areas

- Evaluation of overall performance of various operating departments from the standpoint of:

1. plan of organisation

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
YES:				
3	Extensive	20	41.7	41.7
2	Moderate	12	25.0	66.7
1	Little	8	16.7	83.4
0	NO & N/A	8	16.7	100.
		48	100.0	
Mean: 2.0 S.D.: 1.08 .95 C.I. 1.7 to 2.32				

2. policies in effect

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
YES:				
3	Extensive	23	47.9	47.9
2	Moderate	12	25.0	72.9
1	Little	5	10.4	83.3
0	NO & N/A	8	16.7	100.
		48	100.0	
Mean: 2.13 S.D.: 1.07 .95 C.I. 1.8 To 2.45				

3. procedures being followed

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
YES:				
3	Extensive	38	79.2	79.2
2	Moderate	4	8.3	87.5
1	Little	2	4.2	91.7
0	No & N/A	4	8.3	100.
		48	100.0	
Mean: 2.64 S.D.: 0.85 .95 C.I. 2.4 To 2.87				

continued/ ...

... ..

4. results being achieved

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
YES:				
3	Extensive	23	47.9	47.9
2	Moderate	12	25.0	72.9
1	Little	6	12.5	84.9
0	NO & N/A	7	15.0	100.0
		48	100.0	
Mean: 2.152 S.D.: 1.032 .95 C.I. 1.85 to 2.46				

5. individual performance

Scale	Degree of Involvement	NVC	Pct.	Cum.Pct.
YES:				
3	Extensive	10	20.8	20.8
2	Moderate	16	33.3	54.1
1	Little	9	18.8	72.9
0	NO & N/A	13	27.1	100
		48	100.0	
Mean: 1.54 S.D.: 1.089 .95 C.I. 1.22 To 1.87				

Table (4.7)

Percentage of Internal Audit Effort According to
Categories of Audit Activity and Types of Data

Internal Audit Categories	Types of Audit Data		Totals
	Financial	Non-Financial	
Compliance	35.90	21.98	57.88
Compliance - External	7.30	4.99	12.29
Total Compliance			70.17
Efficiency	7.03	9.18	16.12
Effectiveness	5.59	8.03	13.62
Total Efficiency & Effectiveness			29.83
Totals	55.82	44.18	100.00

Definitions:

Financial data:	i.e., data included in financial statements.
Non-financial data:	i.e., data not included in financial statement.
Compliance-Internal:	Checking compliance with internal controls and procedures.
Compliance-External:	Checking compliance with applicable external laws and procedures.
Efficiency:	Determining whether corporate resources (personnel, property, etc.) are being used efficiently (the ratio of inputs to outputs).
Effectiveness:	Determining whether resources are being used effectively (the relationship of outputs to the desired goals of the corporation).

activity into reviews of efficiency and effectiveness which are based upon non-financial data has grown significantly over the period 1971 to 1976. This clearly upward trend is another indication of the increasing level of internal audit activity into this broader scope.

4.4 (4) Attitude of management toward non-financial audits

Looking for evidence concerning other management's attitudes toward internal audit work done in non-financial areas, the previous analysis is corroborated by Executive Managers' responses to questions 3(c), 4(a,b,c), and 6(ii) in the Questionnaire for Executive Managers - Appendix (C).

4.4.1 In Q.3(c), executive managers were asked to describe which part(s) of their responsibilities had been subjected to internal audits. Their responses were firstly checked with their job titles and main areas of responsibilities (see Q.1 - Appendix (C)), then the answers received were classified in terms of the nature of the operational area being reviewed (i.e. financial versus non-financial). Table (4.8) shows their responses to this question.

Table (4.8)

Aspects of Operational Areas being Reviewed by Internal Audit, as Revealed by Executive Managers

	Number	%
The aspect of operational area being reviewed:		
Financial aspects	12	57
Both Financial & Non-Financial aspects	9	43
	21	100

It seems that internal auditors are generally successful in selling operating officials on the benefit of auditing non-financial aspects related to their areas of responsibility. 47% of executive managers considered internal auditing worked on both financial and non-financial aspects of their tasks - Table (4.8). Yet, some 57% of executive managers considered that internal auditing worked exclusively on the financial aspects of their tasks.

4.4.2 Nevertheless, the inference may be accepted of a *general* indication that internal auditing functions effectively in evaluating matters related to operational areas, but a more explicit analysis is needed. The issue can be illustrated most clearly in the review of compliance where presumably internal audit work is not seriously challenged. Here, the internal auditor is on sound ground when he ascertains the extent of compliance with established policies and procedures. Frequently, however, the important issue is not the *process* of compliance in itself for this is in fact a clerical task but rather using the results of compliance auditing as a basis for evaluating the causes of non-compliance. This analytical audit phase includes recommended actions to limit or decrease non-compliance in the future. The action here will be corrective to the extent warranted, and constructive in a more positive sense when the auditor indicates that adjustments or changes in underlying policies or procedures are what are really needed.

As reported earlier in Table (4.5), more than half of total audit work in evaluating operating performance is concerned with compliance activities. Now, it is appropriate to see to what extent internal auditors are able to recommend actions calling for change in established policies and procedures, *as perceived by auditees who are mainly responsible for operational areas - i.e. executive managers.*

Executive managers were requested to indicate the extent to which internal audits result in change in:

1. Policies by which their responsibilities are governed,
2. Management systems or procedures by which these policies are carried out (Q.4(a) - Appendix (C)).

Data in Table (4.9) show 85.7% of executive managers indicated that policies by which their responsibilities are governed have been changed to a varying extent as a result of internal audits, and *all* of them stated that procedures by which these policies are carried out have been subjected to recommended changes by internal audits. The calculated .95 C.I. indicates a 1.21 to 2.10 confidence interval for the average of population response to changes in policies, and a 1.75 to 2.53 confidence interval for the average of population response to changes in procedures on the 5-point scale used.

This evidence suggests that the extent to which internal audits result in change in policies and

Table (4.9)

Extent of change in operational policies and procedures as perceived by Executive Managers

To what extent internal audits result in change in:

(i) Policies by which your responsibilities are governed?

Scale	Frequency of change	NVC	Pct.	Cum.Pct.
5	Always	-	-	-
4	Mostly	1	4.8	4.8
3	Often	3	14.3	19.1
2	Sometimes	8	38.0	57.1
1	Seldom	6	28.6	85.7
0	Never	3	14.3	100.0
		21	100.0	
Mean: 1.71 S.D.:1.19 .95 C.I. 1.21 To 2.10				

(ii) Management's systems by which policies are carried out?

Scale	Frequency of change	NVC	Pct.	Cum.Pct.
5	Always	-	-	-
4	Mostly	2	9.5	9.5
3	Often	4	19.0	28.5
2	Sometimes	10	47.7	76.2
1	Seldom	5	23.8	100.0
		21	100.0	
Mean: 2.14 S.D.: 0.91 .95 C.I. 1.75 To 2.53				

procedures related to tasks of executive managers is ranging from *seldom* to *sometimes*, though changes in procedures are more amenable to audit work than changes in policies.

The indications are that internal audit work done in this area is appreciated by executive managers. As shown in Table (4.10), 76.2% of executive managers stated that they are satisfied with audit recommendations calling for change in policies and procedures related to their tasks, and 19% of them expressed partial satisfaction. The calculation at .95 level of confidence has resulted in a 2.61 and 2.99 confidence interval on the 3-point scale used for the average of the population response to the question shown in Table (4.9) which clearly indicates a high degree of satisfaction with audit work in this regard.

This is further corroborated by responses to Q.6(ii) - Appendix (C), in which executive managers were requested to indicate their opinion concerning the statement made in Table (4.10). Notice that this statement was negatively worded so that the answer "Disagree" illustrates a favourable and positive attitude. Executive managers' responses to this statement suggest that most (81%) of them do believe that changes to management systems suggested by internal audit correspond to the needed and necessary changes in these systems. The calculated .95 C.I. indicates a 2.64 to 2.98 confidence interval on the 3-point scale used which clearly suggests a positive attitude toward the internal audit work done in this respect.

Table (4.10)

Executive Managers' attitude toward recommended changes made by internal audit in relation to their responsibilities

- To what extent are you satisfied with the internal auditor's recommendations calling for changes in policies and procedures relating to your responsibilities?

Scale	Answer	NVC	Pct.
3	Satisfied	16	76.2
2	Partly satisfied	4	19.0
1	Dissatisfied	-	-
0	No answer	1	4.8
		21	100.0
Mean: 2.8 S.D.:0.41 .95 C.I. 2.61 To 2.99			

- Please indicate your opinion concerning the following statement:

"Most internal audit recommendations calling for changes in management's systems cause unnecessary changes in the area under review."

Scale	Answer	NVC	Pct.
3	Disagree	17	81
2	Uncertain	4	19
1	Agree	-	-
		21	100
Mean: 2.81 S.D.: 0.402 .95 C.I. 2.64 To 2.98			

4.5 Conclusions, up to this point

In accordance with the preceding discussion, the research findings could be summarised at this point as follows:

The scope of internal auditing is changing to include non-financial audit areas.

No longer does there seem to be a preponderance of emphasis on financial audits. However, this does not mean that the financial areas are excluded, but rather that the scope of coverage and the type of emphasis has shifted to the more operational areas - see: Sec. 4.1.1 and Sec. 4.1.3.

In theory, operationa-type auditing is given now more emphasis than the audit of accounting and financial matters. It would appear, however, that the development of internal audit into a concern for a review of controls in operational areas is progressing and it is reasonable to conclude that real upward progress is being made in this regard - see: Sec. 4.1.2 and Sec. 4.3.2.

The accent has also shifted from merely performing compliance audits to one which also embraces evaluating performance aspects relating to efficiency and effectiveness of the operations under review - see: Sec. 4.3.2.

In general, other management, whose main responsibilities and interest are basically concerned with operational activities, seem to

be fairly satisfied with internal audit work done in this regard, though there are other factors that should be investigated in this respect - see: Sec. 4.4.

4.6 The factors which have a bearing upon the effective functioning of internal operational audit.

To obtain the benefits of professional internal auditing certain expectations should first be met by the organisation it serves.

It is necessary that the internal auditor should have a proper standing in the organisation. As indicated earlier, proper standing should be enforced by management support, and this depends upon certain features one of which, and probably of greatest significance, is the provision of internal audit with an *independent* status in the organisation. This, the literature would suggest, must be seen as a function of the level of the officer to whom the head of the audit department reports, (see: Sec. 2.4.3).

It is also believed that the relative size of the internal audit department, the backgrounds of its staff and the quality of its leadership are significant factors in determining whether internal audit tackles operational audits.

Current practice as to organisational status of the internal auditor will be dealt with in the following section, leaving the study of other factors to a later point in this discussion.

4.6.1 Current practice as to organisational status

It is always useful to determine what various types of business organisations are doing in the way of the organisational placement of the internal audit department. Even more useful can be the examination of the approach taken at different points of time, in order to detect trends of one sort or another.

In this context, the title of the officer to whom the head of the audit department reports has been considered as evidence of its standing in the organisation - see: Sec. 2.4. There are however certain limitations in such type of considerations which must be kept in mind.

Business organisations vary greatly; for instance, as to the nature and scope of their activities and, in turn, as to their problems of control. This impacts upon the way in which individual organisational responsibilities are defined and what is meant by individual job titles in the organisation. In the final analysis, these factors bear upon the overall organisational structure and in turn upon the type of internal auditing activities and its organisational status. Consequently, any examination of current practice as to organisational status of the internal auditor must be seen in fairly general terms.

Bearing this in mind, perhaps the most complete examination of current practice available is the Survey of Internal Auditing, 1975 prepared by the I.I.A. and published in 1976. Similar surveys had been made in 1957 and

1968 so that to some extent comparisons can be made between the three points of time. In those surveys the question was asked as to the title of the Executive to whom the Chief Internal Auditor reports. Responses to this question were as reproduced here in Table (4.11).

Based on data in Table (4.11), the I.I.A. Committee pointed out that the trend for reporting to higher levels of management is continued with 54% of the respondents indicating they report to a vice president level or higher in 1975 survey whereas this percentage was 47% in 1968 and only 30% in 1957.⁽⁴⁾

The U.K. Chapter of the I.I.A. asked the same question in its survey of internal auditing in the U.K. - 1976. Based on the replies obtained in this survey - Table (4.12) - the research committee pointed out that:

"... it is clear that in the great majority of cases internal audit departments report within the Finance function, either to the senior man or to his assistant."⁽⁵⁾

In the study which is the subject of this thesis, a similar question to that used in the survey carried out by the professional bodies of internal auditing was asked to audit managers responding. Their response to this question is shown in Table (4.13).

4 The I.I.A. (7), op. cit., p.23,
The I.I.A. (6), and
The I.I.A. (8), "1957 Survey of Internal Auditing", Research
Report No.5 (New York: The I.I.A., Inc., 1958).

5 Smallbone, M.J., et al (1), op. cit., p.5.

Table (4.11)*

Title of the Executive to whom the Chief
Internal Auditor reports in the U.S.A.

Title	1975 %	1968 %	1957 %
Comptroller (and Assistant)	20	32	42
Vice President - Finance	18	24	16
President or Chief Executive	11	10	7
Executive Vice President	8	5	-
Chairman of the Board	7	6	7
Director of Finance	7	-	-
Audit Committee	5	-	-
Director of Administration	3	-	-
Treasurer	3	9	17
Vice President - Treasurer	2	-	-
Vice President Administrative Services	2	-	-
Assistant Treasurer	2	-	-
Manager Financial Planning and Analysis	2	-	-
Vice President Planning and Control	1	-	-
General Accounting Manager	1	-	-
Assistant to Vice President - Finance	1	-	-
Management Committee	-	2	-
Other	4	11	9
Not Answered	3	1	2
Total Mentions	(340)	(308)	(322)

* The I.I.A., Surveys of Internal Auditing, 1975, 1968, and 1957.

Table (4.12)*

Title of the person to whom the Chief
Internal Auditor is directly responsible
(U.K. practice)

Title	Number	%
Chief Executive	21	8
Finance Director	136	55
Chief Accountant and Controller	70	28
Other	4	2
No reply	18	7
	249	100

* The U.K. Chapter of the I.I.A., Survey of Internal Auditing
in the U.K. - 1976.

Table (4.13)

Reporting characteristics of internal audit departments participating in the study

- To whom does the audit manager report organisationally? (Q.16 - Appendix (B)).

Reporting Level	NVC	Pct.	Cum.Pct.
● Reporting level outside the finance function:			
Chief Executive	11	22.9	22.9
Audit Committe	6	12.5	35.4
● Reporting level within the finance function:			
Finance Director	24	50.0	85.4
Chief Accountant/ Controller	3	6.3	91.7
Other	4	8.3	100.0
	48	100.0	

As Table (4.13) shows, in 85.4% of cases, the audit manager reports to a senior executive level or higher. This includes 22.9% where the audit manager reports directly to the chief executive (the equivalent figure reported in the U.K. Chapter's survey is 8% - see Table (4.12)).

Table (4.13) also reveals a new trend in the reporting relationships of in internal auditing which can be recognised in the formation of audit committee of the board of directors in some British companies. In 12.5% of the organisations responding - all with American connections - the audit manager reports to an audit committee of the board.

The formation of the committee is similar in these organisations in that the membership includes the executive to whom the audit manager reports (in most instances, a senior vice-president level) as well as the managing director, in addition to 2-3 non-executive members. On the other hand, some 64.6% of audit managers report to an officer within finance function (the equivalent figure reported in the U.K. Chapter's survey is 83% - see Table (4.12)).

Consistent with the aforementioned research findings, it is reasonable to conclude that the organisational placement level of the internal audit departments is moving upward, and it can be recognised that real upward progress is being made in this regard. It has to be pointed out, however, that the great majority of audit

departments report within the sphere of the finance function - though usually to a reasonably high level.

4.6.2 Effect of reporting level on the scope of internal, operational auditing

It has been claimed that the move from the review of the traditional financial controls to the wider panoply of the total control mechanism has been delayed and made difficult by the fact that the internal audit function is still often seen a part of finance function rather than part of the organisation's total controls.

This argument is often expressed in an assumptive form as "the higher the level to which the audit manager reports the broader the scope of auditing."

An attempt is made in this study to investigate the validity of this so far untested assumption by examining the relationship between the level of the executive to whom the audit manager reports and internal audit's involvement with audit of operational areas. It was hypothesised that "the extent to which operational areas are audited is related to the line reporting relationship of internal audit."

The procedures taken to test this hypothesis were as follows:;

1. Data presented in Table (4.6) and Table (4.13) was used as a basis for carrying out this test.
2. To determine the strength of association between reporting level and internal audit's involvement in evaluating operating performance (under the five heads -

Table (4.6)), the Spearman rank correlation coefficient was calculated and the results of this test are shown in Table (4.14).

Table (4.14) indicates the existence of a degree of positive association between reporting level and the scope of internal operational audit . This evidence suggests that reporting level is one of the important factors (i.e. an independent variable) in view of the effect it has on the aspects of internal operational auditing (i.e. dependent variables).

Consequently, this means that if the head of internal audit reports to higher managerial levels he is more likely to be supported by management and thus his audit scope will be broader. This is in line with the generally accepted view which says "the higher the executive, the broader the scope."

Nevertheless, we should not lose sight of the fact that, although the answers of audit managers to Q.16(a) were given weights to distinguish between (i) reporting level outside finance function, and (ii) reporting level within finance function, the Spearman rank correlation coefficient is only a measure of total correlation to describe (a) the relationship between two variables and (b) its direction (i.e. positive or negative) if such relationship exists. Bearing this in mind, one would be interested to know the impact of reporting level (i.e. independent variable) on the aspects of internal operational auditing - as described in Q.10(v)

Table (4.14)

The relationship between reporting level and the scope of internal operational auditing

Variable Description	r_s	Sign.
Evaluation of overall performance of various operating departments from the standpoint of:-		
● plan of organisation	.26	.088
● policies in effect	.29	.048
● procedures being followed	.36	.012
● results	.39	.008
● individual performance	.40	.007
<p>r_s = Spearman Correlation Coefficient</p> <p>Sign. = Significance = Probability (two-tailed test at .10 level of significance)</p>		

(Appendix (B)) - when the head of internal audit reports to a managerial level (i) outside finance function (e.g. chief executive or audit committee) and/or (ii) within finance function (e.g. finance director or chief accountant).

From the standpoint of this study, this distinction is useful especially when we take into account the viewpoint which holds that the role of the internal audit would be bounded by the responsibilities, practice, and assumptions of the managerial function to which it belongs.

Where internal audit reports within the finance function, the audit department, under a finance director for example, might be restricted in its ability to report to higher management outside the finance function. In short, if within the ambit of the finance function, the literature would suggest it might be difficult for internal audit to expand.

However, the researcher believes, without supporting empirical evidence, that this claim has to date been just a hypothetical assumption. One could not be absolutely dogmatic as different management styles exist in practice. Of course, there are degrees of appropriateness and the practice of internal audit reporting within the finance function (particularly if finance have a role as 'co-ordinators of control') could even be the objective which the internal audit function seeks to achieve.

In view of this, the question which should be answered is whether there exists a significant difference

in the expanding scope of internal audit as a result of (i) reporting outside finance function and (ii) reporting within finance function?

Accordingly, an attempt is made in this study to get an answer to this question. The procedures taken to carry out this test were as follows:-

1. The Mann-Whitney U-test was selected as a suitable statistical test of the data obtained. "It is one of the more popular non-parametric tests and commonly used where the researcher draws two random samples from the same parent population, subjects each to a different experimental treatment, and compares the two on a single criterion to determine whether the two samples differ".⁽⁶⁾
2. Data which served to analyse the answers of audit managers to Q.16(a) (Appendix (B)) was also used to carry out this test. Two main categories were identified (see Table (4.13)) as follows:-
 - (i) reporting level outside finance function (i.e. chief executive and audit committee), and this was given the score (2), and
 - (ii) reporting level within finance function (i.e. finance director/chief accountant/other) and this was given the score (1).
3. Data which served to analyse the answers of audit managers to Q.10(v) was also used in this test

6 Roscoe, J.T., "Fundamental Research Statistics", (New York: Holt, Rinehart and Winston, Inc., 1969), pp.175-180.

to represent the different aspects of internal, operational auditing (i.e. dependent variables) - Table (4.6).

4. Our hypothesis, stated in null form, is that "if the head of internal audit reports to a managerial level outside finance function, the extent to which operational areas are audited would not be significantly differ than that when he reports to a managerial level within finance function." In statistical terms, this could be expressed as follows:-

- (a) H_0 : No difference in the ranks for the two samples (i.e. the two samples are from populations with the same medians).
- (b) H_1 : Higher ranks are associated with one of the two samples (i.e. the two samples are from populations with unequal medians).
- (c) Mann-Whitney U-test, .10 level of significance, two-tailed test (i.e. if $P < .10$ H_0 is rejected and the observed differences in the ranks are significant.

5. At the conclusion of this test, results shown in Table (4.15) are obtained; and based on them, the null hypothesis is rejected. *There is a significant difference in the ranks of the two samples. The data suggest that the extent to which non-financial 'operational' areas are audited is not only related to the line reporting relationship of internal audit,*

but also is more likely to be emphasised when the head of internal audit reports to a higher managerial level outside the finance function.

6. This result is consistent with the earlier finding using Spearman rank correlation coefficient. It is also consistent with what is generally accepted in auditing literature.

As shown in Table (4.15), the non-parametric Mann-Whitney U-test for differences between the two samples results in probabilities which are strong enough to be statistically significant for all dependent variables used in the test at .10 two-tailed level of significance. It is interesting to note that the difference in the ranks for the two samples with respect to some variables is also statistically significant at .05 two-tailed level of significance.

Of particular importance are the evaluations of overall performance of operating departments from the standpoint of (i) results and (ii) individual performance. Since the score given to those who report outside finance function was twice the score given to those who report within finance function, therefore, the difference in the ranks for the two samples with regard to these aspects of internal, operational audit (see above) is specifically due to the impact of reporting level outside finance function.

The efficiency of an organisation is largely dependent upon two factors - personnel and operating

Table (4.15)

The relationship between reporting level and
the scope of internal operational auditing
(Mann-Whitney U-test)

Variable Description	U	Z	P
Evaluation of overall performance of various operating departments from the standpoint of:-			
● plan or organisation	145.0	1.727	.084
● policies in effect	136.0	2.018	.044
● procedures being followed	144.5	2.675	.007
● results	119.5	2.501	.012
● individual performance	119.0	2.397	.016
<p>Z: for any computed U value, z represents the normalised random variable equivalent with mean 0 and variance 1.</p> <p>P: Probability at .10 level of significance, two-tailed test.</p>			

performance. These factors are closely related and the internal auditor must recognise this relationship.

Within the ambit of the finance function alone, it might be difficult for the internal auditor to expand the scope of his audit coverage to include all aspects of operating areas under review.

4.6.3 The Size and Characteristics of the Internal Audit Staffs

In 1975 over 300 companies from 'The Times' 1974 list of top companies responded to a U.K. survey on internal auditing, and 74 from a further 500 local authorities and public utilities. Of these, only 56% of industrial and commercial concerns had internal audit departments whereas 100% of the local authorities and 97% of public utilities had internal audit departments.⁽⁷⁾ In keeping with the current emphasis on internal auditing it is reasonable to anticipate a continued expansion of internal audit provision within industry and commerce as well as universal use of internal auditors in the public sector.

In the study which is the subject of this thesis, Q.4 in Appendix (B) was intended to indicate both the size and characteristics of the internal audit staffs in the organisations responding. The replies of audit managers to this question fell into categories by number of staff engaged in internal auditing as shown in Table (4.16). Table (4.17) provides comparative data derived from the U.K. Chapter's Survey of Internal Auditing

7 Smallbone, M.J., et al (1), op. cit., p.10.

Table (4.16)

Number of Internal Auditors Employed
in the Organisations Responding

Categories by number of staff engaged in internal auditing	Number of organisations	Pct.	Cum.Pct.
1 - 5	18	37.5	37.5
6 - 20	20	41.5	79.0
21 - 50	7	15.0	94.0
> 50	3	6.0	100.0
	48	100	

Table (4.17)*

Number of Internal Auditors

Categories by number of staff engaged in internal auditing	Number of organisations	Pct.	Cum.Pct.
1 - 5	94	38	38
6 - 20	101	40	78
21 - 50	35	14	92
> 50	5	2	94
No Reply	14	6	100
	249	100	

* "How many people are employed in the internal audit department, U.K. based only?"

* Source: The I.I.A., U.K. Chapter, a survey of internal auditing in the U.K. (1976).

in the U.K. (1976) in which a similar question was asked.⁽⁸⁾

Based on data shown in Table (4.16), a large proportion of the organisations responding (79%) tended to employ a small number of internal auditors. This is also evident from the equivalent figure derived from the U.K. Chapter's survey which indicates 78% of the organisations responding to this survey had a number of internal audit staff ranging from one to twenty employees: this is probably due to economic reasons. If this is so, it indicates a lack of understanding of the usefulness and economic advantage of an efficient internal audit coverage within the organisations. One general indicator as to the growth of internal audit coverage within organisations - widely adopted by many researchers - is the number of internal auditors as a proportion of the total number of staff employed within an organisation. In this context, a rule of the thumb to judge the size of an internal audit department within an organisations is about one auditor per one thousand employees.

"This rule of the thumb is the result of studies conducted nationwide by two independent organisations - the National Industrial Conference Board, and the Institute of Internal Auditors."⁽⁹⁾

In a U.K. survey with 387 respondents, 3359,992 were employed with 2,801 auditors - a ratio of one auditor to every 1,200 staff.⁽¹⁰⁾ The equivalent figure derived from

8 Ibid., p.4.

9 Sawyer, L.B. (1), op.cit., p.451.

10 Smallbone, J.M. et al (1), op. cit., p.5.

a more recent study carried out for the I.I.A. (U.K. Chapter, 1977) was one auditor to every 1,378 staff.⁽¹¹⁾ In a German study the ratio was constant in 1963 and 1973 at one auditor to every 1,429 staff.⁽¹²⁾ Of 800 companies randomly selected from the membership of the I.I.A., 343 companies responded to the 1975 worldwide Survey of Internal Auditing carried out by the I.I.A. These companies employed 3,870,714 and had 4,156 internal auditors - a ratio of one auditor to every 931 staff. In 1968 there had been 308 respondents employing 3,913,086 with 3,900 internal auditors - a ratio of 1:1,003.⁽¹³⁾ Worldwide, it is apparent from these figures that there has been a growth of less than 7% in the proportion of internal auditors to all employees in companies that had internal audit departments throughout the period between 1968 and 1975, less than 1% per year. It is certain, however, that the total number of internal auditors has expanded considerably and is likely to continue to increase as more and more organisations establish internal audit functions.⁽¹⁴⁾

11 Chambers, A.D. (8), "Employment in Internal Auditing with special reference to the Graduate", Research Report No.3, (London: The I.I.A., U.K. Chapter, 1977), p.12.

12 Hengt, F.J., op. cit., p.48.

13 The I.I.A. (7), op. cit., pp.69-70.

14 Chambers, A.D. (5), loc. cit.

Nevertheless, some people see that the 'one auditor per one thousand criterion' is only one indicator as to the numerical adequacy of the internal audit staff within an organisation and there can be no 'correct' number. (15)

Discussion with audit managers revealed some other factors determining how large an audit department should be within an organisation. Among the factors pointed out by audit managers were:-

- The objective(s) and scope of the audit department concerned,
- The nature of operations under review,
- The travel load for internal audit staff,
- The number of special assignments requested, and
- The problem of maintenance of qualified audit staff (i.e., a shortage of qualified candidates, high staff turnover, and the difficulty of staff training).

All this indicates that there are many factors other than mere size of organisation that determine the numerical adequacy of the staff within internal audit departments. Nevertheless, the 'one auditor per thousand employees criterion' could be a good indicator to judge the number of persons to make up the audit department within an organisation if it was based on active audit staff only (i.e., the number of internal auditors employed - with the exception of people engaged in

15 Smallbone, M.J., et al, (1), op. cit., p.5.

in clerical and secretarial work - as a proportion of the total number of employees engaged in the organisation). Clerical and secretarial staff are excluded mainly because people who are engaged exclusively on work of this kind do not constitute technical audit staff (i.e., reviewers).

Q.4 in Appendix (B) provided data which was available to carry out this analysis of the number of professional audit staff. The organisations completing the questionnaire were analysed by convenient groups to show the variation in both the size and characteristics of internal audit staffing between the organisations responding. The results of this analysis are shown in Table (4.18). If one eliminates the total number of audit personnel engaged in clerical and secretarial work from all groups shown in Table (4.18), one comes up with a percentage of .092% active audit staff to every 1000 employees (i.e., 1 to 1,087). This seems to be close to the 'one auditor per one thousand criterion' bearing in mind that this rather arbitrary rule of the thumb is in practice modified in the light of the special circumstances of particular organisations.

Among other results reported in the U.K. Chapter's Research Report No.3 (1977), one result was that:

"The number of internal audit employees as a proportion of the total employed varied not only according to the size of organisation (as expressed by the total number employed) but also according to the business sector to which the organisation belong."(16)

16 Chambers, A.D. (8), op.cit., p.13.

Table (4.18)

Size of Organisation and Active Audit Staff

Industry Group Description	Industry & Commerce	Local Authorities	Public Utilities	Total
Number of organisations	39	6	3	48
Total number employed	547430	65350	105570	718350
Total number of auditors	490	179	86	755
Total number of active audit staff:				
Actual	429	148	80	657
Norm	547	65	106	718
The percentage of active audit staff				
Actual	.0784	.2276	.0754	.092
Norm	.100	.100	.100	.100
Criteria adopted:				
1:1000	1:1275	1:439	1:1326	1:1087

The breakdown of percentages by main industry groupings shown in Table (4.18) confirms the result of the U.K. Chapter's study referred to above. It also shows that both 'industry and commerce' and 'public utilities' groups seem to be relatively in line with the 'one auditor to one thousand criterion' whereas 'local authorities' group seems to have much more auditing. This may indicate an increased amount of work to be handled by the internal audit staff, or it may refer to over-involvement by active audit staff in non-audit work (i.e., internal check or administrative work). The fact that there was fewer people referred as engaged in clerical and secretarial staff in this group (as well as in the 'public utilities' group) gives weight to the conclusion that there may be too much involvement by active audit staff in non-audit work in these two groups. Another reason for the additional weighting of audit staff in public sector organisations may be that the need for audit of bodies which are accountable to the public is greater - or at least acknowledged to a greater extent. It is also prescribed by U.K. law for local authorities, health authorities and other public sector organisations. As indicated before, the 1976 U.K. Chapter survey found that internal auditing was present in 97% of U.K. public sector organisations but only in 56% of the top 1000 U.K. private sector concerns. (17)

17 Smallbone, M.J., et al, (1), loc. cit.

4.6.4 Characteristics of internal audit personnel

Traditionally internal auditors have been accountants. The monopoly, though a relatively weakening monopoly of the accountant in internal auditing continues to be the main pattern in the professional practice of the internal audit field. In a recent survey it was found that 75% of U.K. internal auditors had an accounting background and 70% of graduate internal auditors in the U.K. either have, or are obtaining, accounting qualifications.⁽¹⁸⁾ The international survey showed that in 1975 accountancy was still regarded as the most important background for an internal auditor but its priority had slipped from 65% in 1968 to 56% in 1975.⁽¹⁹⁾

A large proportion of internal audit personnel, as well as the leadership of the internal audit function in the organisations participating in this study, have mainly accounting backgrounds. As shown in Table (4.19), 56% of the total number of staff employed on internal audit had an accounting background. Table (4.19) also shows that this accounting bias is clearly indicated regardless of the total number of staff engaged on internal auditing in the organisations responding.

Further analysis of numbers and characteristics of internal audit personnel by main industry groups shows (Table 4.20)) that some 42% of the organisations

18 Chambers, A.D. (8), op. cit., pp.35-43.

19 The I.I.A. (7), op. cit., p.28.

Table (4.19)

Backgrounds of Internal Audit Personnel

Number of Staff Engaged on Internal Audit	Number of Organisations	Total Audit Staff	Acc. Staff		Non-Acc. Staff		C & S Staff	
			No.	%	No.	%	No.	%
2	4	8	4	50	3	37	1	13
3	6	18	9	50	6	33	3	17
4	5	20	11	55	5	25	4	20
5	3	15	10	67	2	13	3	20
6 - 20	20	220	125	57	73	33	22	10
21 - 50	7	224	136	61	60	27	28	12
> 50	3	250	125	50	88	35	37	15
	48	775	420	56	237	31	98	13

Acc. = Accountants as auditors

Non-Acc. = Non-Accountants as auditors

C & S = Clerical & Secretarial Staff

% = As a percentage of total audit staff

Table (4.20)

Analysis of numbers and characteristics of internal
audit personnel of the organisations
participating in the study

Industry Group Description	Industry & Commerce		Local Authorities		Public Utilities		Total	
	NVC	Pct.	NVC	Pct.	NVC	Pct.	NVC	Pct.
Number of Audit Departments Having:								
● Accountants as auditors only.	16	34	3	6	1	2	20	42
● Accountants as auditors more than non-accountants	11	23	1	2	1	2	13	27
● Non-accountants as auditors only	4	8	-	-	-	-	4	8
● Non-accountants as auditors more than accountants	7	15	1	2	1	2	9	19
● Equal number of accountants and non-accountants as auditors	1	2	1	2	-	-	2	4
	39	82	6	12	3	6	48	100

responding still only use accountants in their audit departments, and a further 27% of the organisations concerned have more with accounting backgrounds than all other backgrounds put together.

This accounting bias is also evident from Table (3.7) on page 117 which discloses a wide variety of job titles in use as well as some 87.5% of the heads of internal audit departments in the organisations responding having mainly accounting or financial backgrounds.

The technical aspects of operational auditing are more properly within the areas of competence of other qualified specialists, in a time of specialisation. No man is expert in all business fields, nor can any organisation afford to have on its internal audit staff a specialist in every aspect of the business that is to be audited. However, it is largely agreed that the internal auditor's special competence in the *control* area is what justifies his review of a wide range of operational activities, even though he does not possess special knowledge about the substance of those activities. Despite these considerations, for operational audits to be effective, financial or accounting backgrounds are not enough. The extension of internal auditing into the review of operational efficiency and effectiveness calls for more audit use of up-to-date specialists. A trend which counters the accounting bias in internal auditing, is that new 'disciples' have entered the internal audit field. As shown in Table (4.19), 31% of the total audit

staff employed in the organisations responding were non-accountants. 8% of the organisations use non-accountants exclusively in their audit departments and 19% of them had more non-accountants as auditors than accountants - see Table (4.20). Some researchers have explained this as a result of the recent "operational auditing trend".⁽²⁰⁾

However, the existence of non-accountants in some audit departments cannot only be due to the advent of operational auditing. Some organisations due to the very nature of their activities (e.g. those in banking, insurance, and some highly sophisticated industries) make a practice of using non-accountants on their audit staffs. This practice is long established and predates the more recent operational auditing trend. The 8% of the organisations which use non-accountants exclusively in their audit departments shown in Table (4.20) represent organisations all of whom belong to banking or insurance. On the other hand, some organisations as a result of the new, general use of computer-based information systems make a practice of using specialists in this area as perhaps the first non-accountants to be on their audit staffs. Worldwide, half of audit departments employ at least one auditor trained to write computer extract programmes and 8% of staff are specialist computer auditors.⁽²¹⁾

20 Shain, I.O., op. cit., p.223.

21 The I.I.A. (7), op. cit., p.65.

Recently in the U.K., however, only 16% of public sector organisations employed computer audit specialists within their audit departments. (22)

The practice of using non-accountants within audit departments increases the technical proficiency of internal audit functions and may lead expanding the scope of audit into areas beyond the traditional financial audits - see Sec. 5.3.3. But the appearance of non-accountant specialists on the scene of the internal audit function is not necessarily a direct response to the recent operational trend.

Table (4.19) also indicates that 13% of the total of audit staff employed in the organisations responding belonged to audit personnel engaged in clerical and secretarial work. As long as there is non-audit work to be done, this ratio seems reasonable. However, the subsidiary percentages in Table (4.19) suggest that small sized departments tended to employ a high number on the part of clerical staff, while larger audit departments employed a smaller proportion of clerical and secretarial staff. Among other considerations, the numerical adequacy of internal audit personnel who are employed as clerical and secretarial staff can be evaluated in the light of the extent to which they take away administrative and other non-audit work from active audit staff. The fact that they do not carry out technical audit work (i.e. reviews)

22 Chambers, A.D (5), op. cit., p.57.

means a high number on the part of clerical and secretarial staff represents an increment of audit personnel but most probably not in its proper place. On the other hand, a smaller proportion of audit personnel engaged in clerical and secretarial work evidently would effect the availability of active audit staff time. In such situations, active audit staff would be involved in carrying out non-audit work at the expense of the time of audit work. Otherwise, how would it be possible to explain the example of a commercial organisation with 30 audit staff - all accountants - but with no one engaged as clerical staff. Another example in Table (4.19) is an organisation belonging to the public sector in the U.K. with a total of 109 audit staff including only five persons were engaged as clerical and secretarial staff.

In this context, among the main reasons revealed during discussions with audit managers, in response to the question "why they do not keep records showing the use of the internal audit staff time?" was "too much administrative work with too little clerical audit staff to handle it".

4.6.5 Effect of the size of audit department and the size of the organisation on the scope of internal, operational auditing

Based on the figures reported in the 1968 and 1975 surveys of the I.I.A., the number of internal auditors have been fairly stable between 1968 and 1975 in the

organisations that had internal auditing throughout this period (an increase of less than 7% - i.e. less than 1% per year).⁽²³⁾ In this context, the Harvard study pointed out:

"It appears from the data gathered by the I.I.A. that the number of internal auditors grew only 7% over the period 1968 to 1975, less than 1% per year. Since we have evidence that management audit activity has increased significantly from 1971 to 1976 we infer that this increase has resulted from a reallocation of the internal audit effort away from compliance activities rather than from addition of more audit personnel."⁽²⁴⁾

The evidence mentioned in the above quotation is reproduced in Table (4.7). The use of the term 'management audit' is generally a matter of semantics and the term 'operational audit' is adopted in this study to indicate the broader scope of internal auditing (see Sec. 1.5 et seq).

The empirical evidence reported earlier in this study (see sec. 4.1 et seq esp. Table (4.2)) confirms an increasing tendency towards developing the scope of internal audit into a concern for reviewing operational areas. However, since numbers of internal auditors have been fairly stable over the period 1968 to 1976, it would seem that operational auditing has been adopted at the expense of time, if not of quality, spent on financial and compliance audits. Yet this does not necessarily mean

23 The I.I.A. (7), op. cit., p.70

24 San Miguel, J.G. et al, op.cit., p.11.

that the protective role of the internal auditor has received a lesser degree of emphasis but rather it has not been permitted to dominate the internal auditing approach (see Sec. 7.2.2 et seq). This view was emphasised by A.D. Chambers when he stated:

"It certainly appears that the shift in audit emphasis must have resulted in less audit attention to compliance auditing even though compliance auditing may, to a large extent, be what managements and external auditors consider is the essential nature of internal auditing. This may not necessarily mean that the protective role of the internal auditor is no longer being discharged satisfactorily: a principal justification for the systems approach in internal auditing (which is concerned more with efficiency and effectiveness than with compliance) is that it provides greater protection by identifying systems weaknesses even if it does not always spot particular incidents of systems malfunction."(25)

An investigation of the relationship between internal audit's involvement with reviews of operating areas (Q.10 (y) in Appendix (B)) and the size of the audit department within the organisations responding revealed that evaluations of operating performance tend to increase with the increase in the percentage of active audit staff employed, and this increase reaches its highest scores when the percentage of active audit staff was close to the 'one auditor per one thousand employees criterion' - see Table (4.23). Since this criteria is based on the total number employed within an organisation, Spearman rank

25 Chambers, A.D. (9), "Current Trends in Internal Auditing", Proceedings of the 4th Conference on Recent Developments in Internal Auditing (London: The City University Business School, May 1979), p.194.

correlation coefficients were calculated to cast light on the relationship between the size of organisation - as expressed by the total number of employees - and the incidence of internal, operational auditing as defined in Q.10(v) in Appendix (B).

The findings of this investigation are shown in Table (4.21) and based on them, an inverse, weak association has been found between the size of organisation and each variable thus suggesting an indirect relationship between the size of organisation and the incidence of internal, operational auditing. Further analysis of the relative size of the organisations responding in relation with the same variables defined in Q.10(v) in Appendix (B) has indicated (Table (4.22)) that internal audit's involvement in evaluations of operating departments within the organisations responding tended to increase in the smallest organisations (size (a) in Table (4.22)). Prima facia, this is surprising in the sense that large concerns tend to have large internal audit departments which are in a better position to employ a few non-accountants with the specialist technical skills which equip them to review technical areas. This ability to employ a significant number of non-accounting technical specialists as internal auditors is only likely to apply in the largest internal audit departments. Medium-sized departments will have little opportunity to do so. In fact this is consistent with the findings of this study. While the evaluation of operating performance decreases with the increase in the size of the organisation

Table (4.21)

The relationship between the size of organisation
and internal, operational auditing

Variable Description	r_s	Sign.
Evaluation of overall performance of various operating departments from the standpoint of:- <ul style="list-style-type: none"> ● plan of organisations ● policies in effect ● procedures being followed ● results ● individual performance 	-.17 -.18 -.21 -.12 -.07	.27 .25 .15 .44 .64
<p>r_s = Spearman Correlation Coefficient</p> <p>Sign. = Significance = Probability (two tailed test at .10 level of significance).</p>		

Table (4.22)

The Relationship Between Internal Operational Audits
And the Size of the Organisation

Size By Number of Employees ('000s)	Audit's Involvement in Reviewing Operating Areas (means of scores)*
(a) LT 1	2.10
(b) GE 1 & LT 5	1.70
(c) GE 5 & LT 10	1.40
(d) GE 10 & LT 50	1.94
(e) GE 50.	2.05

Table (4.23)

The Relationship Between Internal Operational Audits
And the Size of Internal Audit Department

Number of Active Audit Staff	Pct. of Active Audit Staff	Audit Involvement in Reviewing Operating Areas (means of scores)*
1 - 5	.064 (1:1562)	1.52
6 - 20	.098 (1:1020)	1.74
21 - 50	.074 (1:1351)	1.60
> 50	.102 (1:980)	2.06

* Highest = 3, Lowest = 1.

up to size (c) in Table (4.22) it increases again for the largest organisations (size (d) and (e) in Table (4.22)).

The inverse, weak correlation detected between the size of the organisation and the scope of internal, operational audit (Table (4.21)), and also the decrease of internal audit's involvement with evaluations of operating areas with the increase in the size of the organisation (Table (4.22)) could be interpreted as a consequence of large organisations needing more compliance auditing - nearly two-thirds of total audit effort spent on reviews of compliance, Table (4.5) - in order to provide reassurance that the extremes of their operations are performing in accordance with established policies and procedures. In other words the larger the organisation the more likely it is that management will depend on internal audit to confirm compliance because they themselves find it more difficult to control compliance. It would follow that a smaller organisation where management finds it easier to control would enable internal audit to concentrate on evaluating operating performance to a greater extent.

4.6.6 Conclusions

In the light of the preceding analysis and discussion the following conclusions seem to be appropriate.

1. The organisational placement level of internal audit departments is moving upward and there exists a general recognition that real, upward progress has been made in this regard. It has to be pointed out however

that most audit departments are still reporting within the finance function but to a reasonably high level - see: Sec. 4.6.1.

2. The extent to which operational areas are audited is related to the line reporting relationships of internal auditing - see: Sec. 4.6.2.
3. If within the ambit of the finance function it might be difficult for the internal auditor to expand the scope of his audit coverage to include all performance aspects of other operating departments. When the audit manager reports to a higher management level outside the finance function (i) more emphasis seems to be placed upon evaluating operating performance in general and (ii) performance aspects relating to operating efficiency and effectiveness have then often been brought into the internal auditor's orbit and been given more emphasis in particular - see: Sec. 4.6.2 and Table (4.15).
4. There are many factors other than mere size of the organisation that determine the numerical adequacy of audit staff in the company. Nevertheless, the "one auditor per one thousand employees" criterion could be a good indicator to judge the number of persons to make up the audit group in a concern when it is based on the ratio of active audit staff, bearing in mind that this rather arbitrary rule of the thumb must in practice be modified in the light of the particular circumstances of individual cases - see: Sec. 4.6.3.

5. The great majority of internal audit personnel, as well as the leaders of the internal audit function, are mainly accountants. Specialists with non-accounting backgrounds have entered the field of internal auditing (e.g. specialists in computers & E.D.P.; engineers; and those with managerial experience in production, personnel, marketing etc.). Such additions can add strength to the capabilities of the internal audit group and enable it to expand its range of services. Yet, it seems as though they have not attained a high level of influence since their corresponding share in the leadership of internal auditing is very small - see: Sec. 4.6.4.
6. An inverse weak correlation is detected between the size of the organisation and the scope of internal audit work in operational areas. It would appear that a smaller organisation (where management finds it easier to effect personal control) enables internal audit to concentrate on operational auditing to a greater extent. In a relatively large organisation internal audit departments seem to be less involved in operational auditing due to the problems of large size (i.e. less frequent and/or less thorough coverage of the audited areas) on the one hand, and more involvement in compliance audit activities, on the other.

In the largest organisations, the scope of internal operational audits tends to increase probably because

of the need of higher management levels to know more about operating areas and/or the feasibility of employing an adequate number of audit staff including non-accounting specialists as auditors to cope with the problems of technically-oriented operational audits - see: Sec. 4.6.5 esp. Table (4.21), (4.22) and (4.23).

CHAPTER 5

INTERNAL AUDIT COVERAGE BY MANAGEMENT LEVELS

Internal audit coverage by management levels is related to the managerial level in the organisational hierarchy to which the internal auditor is able to go in terms of the scope of his review and appraisal (See: Sec. 2.5.2).

Management levels are broadly defined in this study as Administrative-, Executive-, and Lower-Managerial Levels (hereafter referred to as AL, EL, and LML respectively, see: Figure (1) in Appendix (F).

Internal audit is generally considered to be a control device for the purpose of appraising all other controls that management has formulated within the enterprise. Internal auditors as well as management have accepted that without undue question. However, the question which follows is to what extent is the internal auditor able to go upward in the organisational hierarchy so as to bring all related controls into his orbit?

In auditing the accounting and financial aspects of the LML, for example, it is relatively easy for the internal auditor to justify the need for his reviews, and that they should cover all accounting and financial activities. At this level when the auditor ascertains the extent of compliance, or when he goes on to recommend change in procedures, he is on sound ground and probably has his clearest acceptance.

At EL, some operational executives are more involved with basic control problems and related financial implications. The work of these executives is likely to be subject to internal audits and perhaps without any resistance. However, other operational areas at this level are, for one reason or another, more resistant to the internal auditor's appraisal - see: Sec. 5.4.4 and 5.4.5, see also Sec. 2.1 and 2.2.

To cast light on this issue, this chapter seeks empirical answers to the following questions:

1. What levels of the organisation are actually audited?
2. What aspects of operational areas are reviewed at each management level?
3. What are the main limitations upon internal audits at the various management levels?

5.1 What levels of the organisation are actually audited?

5.1.1 It may be useful first of all to note that the investigation of this research area began with the following assumption in mind: "Most internal audit work is concerned with the activities of lower management." (see: Sec. 2.6).

Accordingly, a question that needed to be answered was the extent to which internal auditing permeates the entire organisation.

Question No.8 in the Internal Audit Managers Questionnaire (see Appendix (B)) was designed to glean information indicating the frequency with which each of management levels are held to be within the scope of the work of internal audit departments in the organisations participating in the study. A description of each of the three levels of management as viewed in this study was provided and included in this question. Table (5.1) provides the responses of audit managers to this inquiry. Based on the data in Table (5.1), 71% of audit managers stated that AL in their organisations are subjected to internal audits. As against this, 29% replied negatively.

It must be pointed out, however, that top positions at this level (i.e. the chairman, vice-chairman and/or the president, vice-president) are excluded in six cases representing 12.5% of the total number of the organisations responding.

Table (5.1) also shows that EL appear to be subjected to internal audits in all organisations responding. Further investigation of the responses has indicated that this

Table (5.1)

Management Levels Subjected to Internal Audits in the Organisations Responding

Level	Scale	Frequency of Audit	NVC	Pct.	Cum.Pct.
A · L	5	Always	9	18.8	18.8
	4	Mostly	-	-	18.8
	3	Often	3	6.4	25.2
	2	Sometimes	9	18.8	44.0
	1	Seldom	13	27.0	71.0
	0	Never	14	29.0	100.00
			48	100.0	
Mean: 1.77 S.D.: 1.79 .95 C.I. 1.25 to 2.29					
E · L	5	Always	22	45.8	45.8
	4	Mostly	12	25.0	70.8
	3	Often	8	16.7	87.5
	2	Sometimes	5	10.4	97.9
	1	Seldom	1	2.1	100.0
	0	Never	-	-	-
			48	100.0	
Mean: 4.02 S.D.: 1.12 .95 C.I. 3.70 to 4.35					
L · M · L	5	Always	34	70.8	70.8
	4	Mostly	8	16.7	87.5
	3	Often	5	10.4	97.9
	2	Sometimes	1	2.1	100.0
	1	Seldom	-	-	-
	0	Never	-	-	-
			48	100.0	
Mean: 4.56 S.D.: .77 .95 C.I. 4.34 to 4.79					

does not apply to other vice-presidents at EL in 8% of the total answers.

Without reservation, all audit managers indicated that LML are subjected to internal audits in their organisations (see Table (5.1)).

A general comment which was shared by nearly one-third of the respondents reveals that their answers to this question should be interpreted as applying to the management levels of the *subsidiary* companies (i.e. local managements) that they audited, and this is specially relevant in considering the subjection of AL to internal audits.

5.1.2 It is interesting to go a little further and to have a look at the ratios attached to the 5-point scale used. As shown in Table (5.1), the pattern of these ratios suggests that the lower one goes in the organisational hierarchy, the more thorough is the audit coverage of the levels of management being reviewed.

Put another way, if the frequency of audit coverage is interpreted as indicative of internal audit time spent, this evidence indicates that allocated internal audit time is inversely proportional to the levels of management in the organisations responding. It seems safe to say that the higher the level of management, the less the frequency with which it is liable to be subject to internal audits.

As a statistical test of reliability, the calculation at ".95 level of confidence" has resulted in a 1.25 to 2.29

interval for the average of audit coverage at AL. This evidence means that the average of audit coverage at administrative levels is between *seldom* to *sometimes* (see: Table (5.1)). This casts a shadow of doubt as to whether AL are actually subjected to effective internal auditing.

However, as we move towards the levels below AL, the situation changes markedly. The calculation of the same statistical measure of reliability (see above) has resulted in a 3.70 to 4.35 (i.e. *often* to *mostly*) confidence interval for EL's, and a 4.40 to 4.79 (i.e. *nearly always*) confidence interval for LML (see Table (5.1)).

Recapitulating, then, the evidence reported above indicates that *the levels of management whose activities are subject to internal audits are mainly executive and lower managerial levels. Administrative levels are sometimes subject to internal audits.*

5.2 What aspects of audit areas are actually reviewed?

5.2.1 This question concerns the extent to which the internal auditor goes beyond the traditional accounting and financial control aspects to other types of non-financial "operational" areas *at each management level.*

To cast light on this issue, Q.11 in Audit Managers Questionnaire (Appendix (B)) was used. In this question, three statements were introduced to audit managers to provide them with an opportunity to indicate their views. These statements were designed to show whether (a) the scope of internal audit is providing a wider coverage of the entire organisation *in general* and, (b) to indicate

the nature of auditing *at each management level*.

The first statement says: "Most internal audit work is concerned with the accounting and financial aspects of the lower managerial (i.e. supervisory) levels." In response to this statement, Table (5.2) shows that 63% of audit managers do not believe that this is the case and, 4% were uncertain. Yet, one-third of the respondents agreed. Considering that more than half of audit time in the organisations responding is spent on internal control reviews which are mainly concerned with the accounting and financial aspects of audited areas (see: Sec. 4.2), it is perhaps not strange that 33% of audit managers agree with the implication to be found in the first statement shown in Table (5.2) as this is evidently on the basis of their experience. The calculation at ".95 level of confidence", however, has produced a 1.44 to 1.98 confidence interval for the average of the population responses to this statement. This evidence suggests a mildly negative attitude between internal auditors toward the implication of the first statement in Table (5.2).

The second statement says, "The scope of internal audit work has extended into non-accounting and non-financial aspects of executive levels." In response to this statement, it appears that internal auditors intended to emphasise their positive attitude toward broadening the usefulness of internal auditing into a concern for non-accounting and non-financial control aspects of executive levels. Apart from the 12% of audit managers who expressed some

doubts as to the implications of this statement, the majority (88%) agreement with the second statement shown in Table (5.2) confirms its validity. This is further supported by the information deduced from the calculation at ".95 level of confidence" which indicated a 2.78 to 2.97 confidence interval for the average of the population response to this statement (see Table (5.2)). This evidence suggests the existence of a strong majority opinion of internal auditors to the implication of the second statement in Table (5.2).

Since most internal audit departments are involved in evaluating the overall performance of various operating departments (see: Table (4.4)), the majority agreement that exists between internal auditors with the second statement in Table (5.2) is what we would expect.

To complete the picture, audit managers were also requested to indicate their opinion concerning the third statement which says: "Internal audit attempts to cope with reviewing tasks of administrative levels." Table (5.2) shows that audit managers responded to this statement in a slightly different manner than they did to the first two statements. A minority of audit managers (14%) replied in the negative, expressing disagreement. Some 17% of the respondents were uncertain. As against this, a relatively strong majority opinion (69%) among audit managers expressed agreement with the third statement in Table (5.2). The calculation at ".95 level of confidence" has produced a 2.33 to 2.75 confidence interval for the

Table (5.2)

Aspects of Control Reviewed at various Management Levels,
as Perceived by Internal Auditors

	Scale	Type of Agreement	NVC	Pct.
1. Most internal audit work is concerned with the accounting and financial aspects of the lower managerial levels.	1	Disagree	30	63
	2	Uncertain	2	4
	3	Agree	16	33
			48	100
	Mean: 1.71 S.D.: .944 .95 C.I. 1.44 to 1.98			
2. The scope of internal audit work has extended into non-accounting and non-financial aspects of executive levels.	1	Disagree	-	-
	2	Uncertain	6	12
	3	Agree	42	88
			48	100
	Mean: 2.8 S.D.: .33 .95 C.I. 2.78 to 2.97			
3. Internal audit attempts to cope with reviewing tasks of administrative levels.	1	Disagree	7	14
	2	Uncertain	8	17
	3	Agree	33	69
			48	100
	Mean: 2.54 S.D.: .74 .95 C.I. 2.33 to 2.76			

average of the population response which also confirms a strong majority agreement between internal auditors to the third statement in Table (5.2).

We must proceed with caution in the interpreting of this last response. It is good to see that most internal auditors do attempt to cope with reviewing the tasks of administrative levels, but what really matters is the extent to which these tasks of AL are in fact reviewed by the internal auditor - a matter that will be dealt with at a later point in this study (see: Sec. 6.4).

Sticking to the main theme of the discussion, a closer examination of the audit managers' responses to the three statements shown in Table (5.2) has revealed a pattern which indicates that their responses tend to be skewed towards the positive end of the three-point degree-of-agreement scale used. This evidence suggests that the majority opinion of internal auditors is in the same positive direction. Hence, on the basis of their experience, most internal auditors do believe that the scope of internal audit is changing to include control aspects beyond those of an accounting/financial nature and, at management levels above that of the lower management.

5.2.2 It could be argued that it is not simply a matter of whether the activities of a particular level of management are seen as being subject to internal audit, which determines the extent of effective internal audit coverage. What really matters is the actual nature of the auditing

work which is done. Therefore, further analysis of the topics of audit reports produced by the internal audit departments concerned was considered necessary to get a clearer picture.

This investigation was based on an analysis of audit points made to management, in the organisations responding to this phase of the study, in order to determine the levels of management whose activities would be affected by the audit points made. The type of operational areas being reviewed (i.e. financial v non-financial "operational" areas) was also distinguished.

Before discussing the results of this analysis, it is appropriate to refer first to the conceptual framework within which the investigation was carried out.

1. Financial and non-financial "operational" areas are interpreted as previously defined in Chapter (2) - see: Sec. 2.5.1, also pp. 125-126.
2. The term "management" is described in this study as an internal organisational process - see: (2) and (3) in Appendix (F). There are two distinctive parts to this description viz:
 - (a) certain and basic tasks or functions to be done; from this angle internal audit coverage was approached and empirically investigated as cited in chapter (4).
 - (b) direct individual responsibilities to be carried out by the people who run the business; this part of the management process is the starting point for our investigation here.

3. It is commonly known that all organisations distribute authority and responsibilities vertically in gradations called levels - and as broadly defined in this study - ranging from that of AL at the top to EL (i.e. operating management), and to lower managerial (i.e. supervisory) level near the bottom - see Figure (1) in Appendix (F).
4. The main common ground between management members at all levels and internal auditing lies in the control process. Among the ways of considering the control process is in terms of its design and implementation - see (7)(d) in Appendix (F). This way of approaching the control process is in line with viewing management members as controllers with identified responsibilities either as policy-makers, designers of plans and methods or organisation (i.e. those who are concerned with design phases) and/or executives (i.e. those who are mainly concerned with implementation of policies and designed plans).
5. Considering (3) and (4) (above), AL are mainly responsible for design whereas EL and LML are concerned basically with implementation, and in line with this audit recommendations made in connection with design phases can generally be considered as audit points which comment on tasks of AL, and audit recommendations related to implementation phases can generally be considered as audit points which comment on tasks of EL and LML. However, since LML have less discretion

and less influence in the execution of operational policies and plans than EL, and their function is close to the day-to-day activities of rank-and-file work, audit points which comment on procedural aspects and basic control problems can be regarded as points relating to LML.

6. Nevertheless, interpretation of the results of this investigation (Table (5.3)) should be considered with the following notes in mind:

(a) Some audit points do not have the specific character either of design or implementation, yet do lend themselves to easy allocation to a particular management level. Examples of such audit points are:

(i) all audit recommendations which highlight situations in which management members are involved with irregularities.

(ii) all audit recommendations made in connection with the technical aspects of operational areas (i.e. at EL).

(iii) all audit recommendations which comment on the quality of individual performance at various management levels.

(b) Audit points at EL might tend to be more profound (and the result of more high powered work) than audit points at LML.

(c) The organisation hierarchy is pyramid shaped. There are more LML staff than EL, and more EL

staff than AL. Fewer audit points at higher managerial levels may not therefore imply less thorough audit coverage.

- (d) An audit recommendation at LML or at EL is, in one sense, an audit recommendation at AL - to the extent that AL has established internal audit in order to review LML and EL on behalf of AL.

5.2.3 Several conclusion appear appropriate from the results shown in Table (5.3):

1. 90% of audit points made to management in the organisations concerned relate to the activities of both executive and lower managerial levels in these organisations (36% for EL, and 54% for LML, Table (5.3)).

This evidence suggests that management levels whose activities are subject to internal audits are basically executive and lower managerial levels. This is consistent with the earlier result illustrated in Table (5.1).

2. It appears that AL are given a small portion in available audit time since their corresponding share in the total number of audit points made represents only 10% (Table (5.3)). This casts doubt on whether they are actually subjected to effective internal audits in the organisations responding (see Sec. 5.3.1, see also Table (5.5)).

Table (5.3)*

Aspects of Control Reviewed at Various Management
Levels, as Deduced from an Investigation of Audit Reports

The Levels of Management whose work is affected by internal audit points made	Number and proportion of audit points made				Total	
	Aspects of control being reviewed					
	Financial aspects		Non-financial aspects			
	Number	Pct.	Number	Pct.	Number	Pct.
Administrative Levels	228	90	26	10	254	10
Executive Levels	696	76	218	24	914	36
Lower Managerial Levels	1110	81	260	19	1370	54
TOTAL	2034	80	504	20	2538	100

* See: Secondly Q.7(b) - Appendix (D)

3. Generally, it seems that the accent has relatively shifted from internal audit of the lower levels towards one which also embraces the audit of other management levels. This is illustrated by the fact that 46% of audit points made are concerned with tasks of management levels *above* that of the lower management (Table (5.3)).
4. Based on the comparison between the proportion of audit points as financial aspects and the proportion of audit points made on non-functional aspects at all levels, it seems that the internal auditor is more able to conduct a review of the accounting and financial control aspects at any management level than he is to conduct a review of non-accounting and non-financial areas. This could mean that all levels of management are in favour of internal, financial audit. Nevertheless, it can be recognised that the ratios of financial audit points to non-financial audit points at each management level are distributed as follows:
9:1 for AL, 3:1 for EL, and 4:1 for LML. Based on these ratios, the percentages introduced in Table (5.3) could be re-analysed as shown in Table (5.4).
The percentages shown in Table (5.4(b)) suggest that "operational" (i.e. non-financial) auditing is done more at executive levels (43%) than is financial auditing (34%) and that is a consequence of the nature of operational auditing - (i.e. executive level managers tend to have responsibility for operations

Table (5.4)

Aspects of control reviewed at various
management levels

(a) Ratio analysis of audit points according to aspects of control being reviewed at each management level.

	Financial	Non-Financial	Total
	%	%	%
Administrative Levels	9	1	10
Executive Levels	27	9	35
Lower Managerial Levels	44	10	54
	80	20	100

(b) Distribution of total ratios of audit points related to financial and non-financial aspects at each management level.

	Financial	Non-Financial
	%	%
Administrative Levels	11	5
Executive Levels	34	43
Lower Managerial Levels	55	52
	100	100

whereas administrative levels do not).

On the other hand, financial matters are of great importance to AL (hence 9% as opposed to 1% in (a) Table (5.4), and the responsibility for maintaining the accounting systems perhaps tends to be a LML rather than EL responsibility).

Conformably, total internal audit effort seems to be disproportionately in favour of financial auditing at both administrative and lower managerial levels whereas, at executive levels it is biased to operational auditing - which would be expected in view of the levels of interest and responsibility that the three managerial levels have for these matters. For instance, the more direct impact of external, financial auditing on AL (i.e. external auditing acts as a check upon the top level directors and as a precaution against fraud on the part of employees) makes these top managerial levels aware of the fact that the accounting and financial aspects of their activities would in any case be subjected to external, financial audits; there is therefore more to be gained than lost by subjecting these aspects to internal audits. The audit committee of the board is an indication of the emphasis that AL's place upon finance and accounts. Typically, an audit committee will include a few AL's in its membership, or at least in attendance.

As far as internal audits apply to the accounting and

financial aspects of AL (or indeed for that matter at any other level), management considers the internal auditor to be competent and welcome. On the other hand, higher management's perception of the internal audit function, and their attitude towards the internal auditor's role within the organisation, have an impact upon the internal auditor's activity. AL approve of internal audit's effort to extent its coverage to operational areas within the sphere of executive levels because this reveals information which extends their own knowledge - in particular, internal auditors may be able to provide clear reasons for problems in operational areas - see: Sec. 2.1 and 2.2.

Since most lower management work is concerned with the procedural aspects and basic internal controls with which internal auditors are already familiar, management at AL believes that the use of the internal auditor's capability in accounting and finance represents a very important way in which additional assurance can be provided to satisfy both (a) the owner's need for additional protection of their investments, besides external audits, and (b) AL's protection against irregularities at lower levels - see: Sec. 1.1 and 1.2.

5. Other important factors in determining whether internal auditors tackle the reviews of particular management levels may be:

- (a) the organisational status of the audit department within the organisation,
- (b) the size of the organisation, and
- (c) the size of the internal audit department and the backgrounds of audit staff.

Discussion concerning these factors and their effect on the work of internal audit will be dealt with under Sec. 5.3.

5.2.4 It is useful at this stage to note that in the I.I.A. Research Report No.19, 1975, a question that was asked in the context of operational auditing was "What levels of the organisation are audited?"⁽¹⁾

The respondents were structured to indicate their responses on both the *current extent* and the *desired extent* of audit at each management level. The responses to this question are reproduced in Table (5.5).

Table (5.5)*
Management Levels Evaluated in Operational Audits
(Internal Audit Practice in the USA)

Level of Management	Evaluated in Represented Organisations	Should be Evaluated
	%	%
Top	55	76
Middle	95	97
Lower	97	91

* Source: The I.I.A. Research Report No.19, 1975

1 The I.I.A. (5), op.cit., pp.22-23

Based on the data in Table (5.5), middle and lower management appear to be evaluated in nearly all of the organisations. There was also no significant difference between the actual extent of evaluation of these two levels and the desired extent.

It can also be recognised that 76% of the respondents indicated the desirability of subjecting top-level management to operational audits, whereas only 55% of them actually did so at the time of the study.

These results indicate that the internal auditor becomes able to work higher in the organisational hierarchy in the conduct of his non-financial "operational" audits. The fact remains, however, that most internal audit work in this respect is still concerned to a certain extent with the activities of executive and lower management. At administrative levels, the internal auditor has not yet established himself well.

According to the I.I.A.'s research, some respondents who were not allowed to audit top-level management and who did not desire to do so expressed the view that:

"No real utility was seen in performing operational audits at this levels", and "First, operations are under the control of middle- and lower-level management. Thus, the auditor is able to audit the activity that he desired to evaluate. Second, the payoff function on audits of top-level management is low. Third, the auditor may not be competent to evaluate management at this level. Also, top-level management sometimes reacts negatively to criticism by the auditor."(2)

2 Idem.

It is interesting to note that the definition of "operational auditing", used in the I.I.A. Research Report No.19, and on which these findings were based, indicates that in operational auditing "financial data may be a source of evidence."⁽³⁾ In addition, 51% of the respondents to this research indicated that "operational auditing includes financial auditing."⁽⁴⁾

But in response to the question "What levels of the organisation are evaluated in the operational auditing?" (see: 5.2.3), the distinction between both types of data - financial and non-financial - being audited at each management level was not illustrated.

The more recent survey of internal auditing 1975, carried out by the I.I.A. and published in 1976 in the USA, disclosed that "operational auditing" represents roughly 50% of internal auditing efforts⁽⁵⁾ - see Sec. 4.2. In 1976, however, another study carried out in the USA too, found totals of 55.82% for internal audits using financial data and 44.18% for internal audits based on non-financial data.⁽⁶⁾ (see: Table (4.7)).

However, the findings in the last two studies did not relate to the amounts of the internal auditing effort

3 Ibid., p.51

4 Ibid., p.33

5 The I.I.A. (7), op. cit., p.9

6 San Miguel, J.G., et al, op. cit., pp.5-10.

being spent on auditing each type of data (i.e. financial and non-financial) *at each management level*. This particular distinction is made in this study (see: Table (5.3)).

Conclusion

The foregoing analysis and discussion indicates that the scope of internal audit coverage has extended to include reviews of aspects of control beyond those of an accounting/financial nature and at management levels above that of the lower management.

It must be emphasised, however, that the levels of management whose activities are subject to internal audits are mainly executive and lower managerial levels. Administrative levels are also sometimes subject to internal audits (Sec. 5.1 and Sec. 5.2.4).

On the other hand, total internal audit effort appears to be disproportionately at administrative and lower management levels for financial auditing and at executive levels for operational auditing - this is largely due to the respective interests and responsibilities that the three levels of management have for these matters (Sec. 5.2.3).

5.3 Causal limitations on internal audits of management levels

The foregoing discussion and analysis have identified some limitations which prevent the internal auditor from being of maximum effectiveness in auditing management levels. Now, it is intended to test to what extent these limitations affect the internal auditor's efforts in this respect.

5.3.1 Firstly: Limitation of Organisational Status

The new "Standards for the Professional Practice of Internal Auditing" provide that "The organisational status of the internal audit department should be sufficient to permit the accomplishment of its audit responsibilities."⁽⁷⁾ As related to the definition and establishment of the internal audit department's responsibilities, this means that it is regarded that organisational status is a key dimension in determining how effectively their responsibilities will be carried out in actual practice. In other words, organisational status (which is the level in the organisational hierarchy at which the audit department is placed and the officer to whom the head of the audit department reports) determines to a major extent the authority of the internal auditor. It also discloses to others in the organisation the degree of commitment that higher management has to the nature and scope of the internal auditor's role (see: Sec. 2.4.3).

In this context, an examination of current situation as to the organisational status of the internal auditor (see: Sec. 4.5.1) has indicated that the organisational placement level of the internal auditing function is moving upward, though in most cases remaining within the finance function. This upward progress will enhance the auditor's independence, and in turn might lead to the provision of adequate authority to ensure a broad audit coverage. There are, however, major limitations to this

7 The I.I.A. (1), op. cit., p.100-1.

reasoning which must be kept in mind.

For the internal audit function to be effective, the internal auditor should not ideally be attached to the administrative area whose work he is expected to review and appraise. If this is true, there are problems if internal audit reports within the finance function or for that matter in any other function. Since these functions would all be subjected to internal audits, this would evidently impair the independence of the internal auditor or at least would probably in some other way bear upon the overall effectiveness of audit activities in these functional areas which would, after all, be governed by the personality and wishes of the line manager to whom the internal auditor reported. Even more, in such situations, the internal auditor might not be welcome outside the functional area within which he reports.

Another aspect of organisational status has in some cases been the organisational position of the internal auditor himself. That is, the internal audit department would be better able to deal with various functional areas when its head is given the respect of an equal by the manager responsible for the functional area under review, and this can only be obtained through the appropriate organisational level of Audit.

The impact of these limitations on internal audit coverage by management function is practically tested and the related research findings are reported in Chapter (4) (see: Sec. 4.6.2). Here, the impact of these limitations

will be practically tested but the focus now is on their effect on internal audit coverage by management levels.

Table (5.6) outlines the levels of management whose activities are liable to be subject to internal audits in the organisations responding. It also shows the organisational levels of the managers to whom the heads of the internal audit departments in these organisations report.

As Table (5.6) illustrates, at both executive and lower managerial levels, in most cases, the organisational level of the manager to whom the head of audit department reports is higher than the level of the auditee (85% for EL, and 100% for LML). In some other cases they are both of the same organisational level (79% for AL, and 15% for EL, see Table (5.6)). This pattern suggests a reasonable degree of independence for the first larger group, and the possibility for the second smaller group of some independence depending upon the influence of the manager to whom the head of the audit department reports.

Yet, in 21% of the valid cases at administrative levels the head of audit department reports to a manager whose organisational level is lower than that of the auditee (see Table (5.6)). In such cases, both the head of the audit department and the manager to whom he reports are then placed in the position of having to review and to report on areas under the direct control of their superiors and consequently might feel under pressure to soften the audit findings should they otherwise be too critical. This casts a shadow of doubt on the effectiveness

Table (5.6)

The Relationship between Reporting Level and Internal Audit Coverage, by Management Levels

Management levels subject to internal audits	NVC	Pct.	The level of the manager to whom the head internal auditor reports			
			Administrative		Executive	
			NVC	Pct.	NVC	Pct.
Administrative Levels	34	71	27	79	7	21
Executive Levels	48	100	41	85	7	15
Lower Management	48	100	41	85	7	15

of internal audits which relate to tasks of administrative levels.

Recalling the earlier findings cited in Chapter 4 (see: Table (4.13)), in 6% of the organisations responding the head of audit department reports to the chief accountant. As indicated previously in this discussion, since the function of this officer himself should be subjected to internal audit reviews, this would certainly impair the independence of the internal auditor with regard to audits within this area. An internal auditor who reports to any functional head, specially within the finance function, could easily find himself in a similar position, though the finance director for instance is much better than the chief accountant.

As a general point, it would seem that the higher the level of reporting responsibility the head internal auditor has, the better it will be. If that is the right approach, then the Chairman of the Board of Directors would be the ideal choice. But in practice this actually might not be the best solution. It could well be that such an individual is not able to give the internal auditor the attention he should have, and in turn he might become isolated from higher management and not be able to ask for and receive necessary support in critical situations.

Furthermore, we should not lose sight of the fact that such a reporting relationship might leave the internal auditor in unpleasant and sensitive situations once tasks of top position are held to be within the

scope of internal audit work. If his full and fair report is critical of these top organisational positions, it may be the last report he is given the opportunity to present.

When the head of the audit department reports to an audit committee of the board of directors, he will probably not be under such pressures to soften his findings of internal audits of administrative levels.

5.3.2 Secondly: Limitations of the size of the organisation

The size of the organisation as expressed by the total number of employees has a direct bearing on subjecting management levels to internal audits.

As a formal test of correlation, Kendall Correlation Coefficients were computed for various levels of management which are held to be within the scope of internal audit, in relation to the size of organisation. Table (5.7) shows the results of this test and, based on them, a weak direct (i.e. positive) degree of association exists between size of the organisation and the frequency of audit coverage at administrative levels. This positive degree of association means that AL are more likely to be subject to internal audits with the increasing size of the organisation. It is recognised, however, that the higher one goes in the organisational hierarchy, the less the frequency of audit coverage will be (see: 5.1.2), and this means that there is less auditing at AL than EL; and in turn less auditing at EL than at LML.

This recognition is true from the standpoint which considers the organisation as a whole entity. However,

Table (5.7)

The Relationship between Size of the Organisation
and the Frequency of Audit Coverage, by
Management Levels

Management levels subject to audits	r_s	P.
Administrative Levels	+ .080	.07
Executive Levels	- .078	.09
Lower Management	- .170	.10

r_s Kendall Correlation Coefficient

P. Probability (two-tailed test at .10 level of
significance) i.e. $r_s P \leq .10$ 2-tailed test.

the organisation could be considered as a whole entity with its subsidiaries (i.e. holding company with its subsidiary companies). Each of these subsidiaries has its own organisational structure in which one can see the same gradations of management levels. In such a situation, size of the organisation has a direct bearing on management information needs. Higher management in the parent company, therefore, relies upon its internal audit staff to bridge the gap of communication by reporting evidence of the quality of operations and the quality of control of the various management levels within the subsidiary companies - the performance of administrative levels is likely to be of particular interest.

Accordingly, the positive association between the frequency of audit coverage by administrative levels and size of organisation could be interpreted largely as being a consequence of the largest concerns having subsidiary companies.

As one moves towards management levels below those of administrative levels, we find an inverse (i.e. negative) degree of association between the frequency of audit coverage at these levels and the size of organisation (see Table (5.7)). This evidence suggests less frequent and/or less thorough coverage of the audited areas at both executive and lower managerial levels with increasing size of the organisation (see: Sec. 4.6.4).

Further analysis of *the relative largeness* of the organisations responding in correlation with the frequency of audit at each management level indicates (see: Table (5.8))

that all management levels are more liable to be subject to internal audits in the smallest organisations (size (a) in Table (5.8)). In these organisations internal auditors appear to have less of a problem of large size which might lead to either less frequent and/or less thorough coverage of the audited areas.

Yet, these problems of large size seem to be more restrictive with the increase in the size of the organisation up to size (c) shown in Table (5.8). However, the frequency of audit coverage at each management level tends to increase in the largest organisations (size (d) and (e) in Table (5.8)). This supports the earlier explanation which indicates that higher management is generally aware of the complexities of conducting operations from widespread locations due to the increase in size of the organisation and, therefore, it looks upon its internal auditor as its 'eyes and ears' to feedback information as to the quality of judgement by local managements. Possibly, it could also be due to the employment of an adequate number of active audit staff to cope effectively with the problems of the large size of the enterprise (see Se. 4.6.5) - another aspect which will be further dealt with in the following subsection.

5.3.3 Thirdly: Shortage of audit staff and lack of non-accountant specialists

As previously indicated, the problems of the maintenance of an adequate number of internal audit staff (e.g.: shortage of qualified candidates, high audit staff turnover, the heavy travel requirement), and the

Table (5.8)

The Frequency of Audit Coverage, by Management Levels
(According to the Relative Largeness of the Organisations
Participating in the Study)

Size of the Organisation (000's of Employees)	NVC	Pct.	Frequency of Audit (means of scores)*		
			AL	EL	LML
(a) LT 1	6	12.5	2.2	3.9	4.0
(b) GE 1 & LT 5	11	23.0	1.5	3.8	3.8
(c) GE 5 & LT 10	9	18.5	1.4	3.5	3.7
(d) GE 10 & LT 50	19	39.5	1.7	3.7	4.0
(e) GE 50	3	6.5	2.7	4.0	4.0
	<u>48</u>	<u>100</u>			

*Highest 5, Lowest 1 - see Table (5.1)

AL: Administrative Levels
EL: Executive Levels
LML: Lower Managerial Levels

LT: Less than
GE: Greater than or
Equal to

lack of other non-accountant specialists in internal auditing were identified by many respondents as being limitations which prevent the audit department from being of maximum usefulness to the organisation it serves.

Turning first to the problems of the maintenance of an adequate number of internal audit staff, an investigation of the relationship between the frequency of audit coverage by management levels and the relative size of the audit department in the organisations responding has revealed that *all* management levels in these organisations are more likely to be subject to internal audits with the increase in the ratio of active audit staff employed - Table (5.9), and this is most likely to be true when this ratio is close to the "one auditor per one thousand employees" criterion. This is consistent with the earlier findings report under Sec. 4.6.5 esp. Table (4.23).

Evidently, the maintenance of an adequate number of internal audit staff, among other things, will increase the total effectiveness of the audit function within an expanded role which will be beneficial to the organisation in its various operating areas. This was also emphasised by some audit managers during interviews - see: Q.1(ii) in Audit Managers' Interview Schedule, Appendix (D). They expressed a desire to extend the scope of their audits but the main reasons for not doing so were the large size of the organisation and the shortage of employed audit staff, as the following comment reveals:

Table (5.9)

The Frequency of Audit Coverage, by Management Levels
 (According to the Relative Size of the Audit
 Department in the Organisations Responding)

Number of audit staff	Ratio of active audit staff*	Frequency of audit at each level (means of score)**		
		Administrative	Executive	Lower
1 - 5	.064 (1:1562)	1.5	3.7	3.9
6 - 20	.098 (1:1020)	1.9	4.0	4.2
21 - 50	.074 (1:1351)	1.7	3.3	4.0
> 50	.102 (1:0980)	3.0	4.3	4.4

* Total number of audit staff with the exception of people engaged in clerical work to every thousand employees in the organisation.

** Highest 5, Lowest 1 (see: Table (5.1)).

"My Group has several diverse interests with addresses at approximately 50 locations from ... to ... I have available to me 4 full-time auditors. Whilst I would like to engage in internal auditing in a more sophisticated way I am severely limited by resources."

Based also upon the interviews, it has been indicated that audits of the accounting and financial control aspects at all management levels are given precedence in the performance of internal audit activities. This does not mean less perceived desirability of subjecting non-accounting and non-financial control aspects to audits, but rather reveals statutory requirements and, sometimes, pressures from external auditors with whom internal auditors maintain close relationship "to ensure adequate coverage of accounting and financial areas". As a result of these priorities, some audit managers indicated that annually they had to complete their accounting and financial audits first and then, *as time permitted*, they would proceed to carry out reviews of non-accounting and non-financial areas.

The broader scope of the internal auditing activities has very naturally increased the need for person who have qualifications apart from accounting. In this context, there is a viewpoint which holds that among other obstacles which inhibit the internal audit function from extending its scope effectively into other operational areas may be the fact that most internal auditors are qualified accountants. An attempt has been made in this study to test this supposition. This has been done through an investigation of the characteristics of

internal audit staff backgrounds in correlation with the frequency of audit coverage by management levels (see: Q.4 and Q.8 in Appendix (B)).

As a first step, Kendall Correlation Coefficients were computed to highlight the degree and direction of association between the number of accountants employed as auditors in the organisations concerned and the frequency of audit coverage at each management level in these organisations. As a second step, the same procedure was carried out with respect to the number of non-accountants employed as auditors in the organisations concerned. Thirdly, a comparison was made between what came to light in the first two steps of this test. The results of this comparison are tabulated in Table (5.10), and based on the data in this table several conclusions seem appropriate:

1. There exists a positive degree of association between the *number of accountants* who are employed as auditors in the organisations responding and the frequency of audit coverage at *administrative levels* in these organisations. Although it is a relatively weak degree of association ($r_s = .16$), it is statistically significant at .95 level of confidence (i.e. $P \ll .10$ 2-tailed test, see Table (5.10)).
2. As against this, there is an inverse, negative degree of association between the number of *non-accountants* who are employed as auditors in the organisations concerned and the frequency of audit

Table (5.10)

The Relationship between Characteristics of Internal Audit Staff backgrounds and the Frequency of Audit Coverage, by Management Levels (in the Organisations Participating in the Study) .

Management levels subject to Audits	Correlation with Accounting Staff		Correlation with Non-accounting Staff	
	r_s	Significance (P \leq .10 2-tailed)	r_s	Significance (P \leq .10 2-tailed)
Administrative Levels	+ .16	.100	- .11	.29
Executive Levels	- .20	.055	+ .24	.090
Lower Managerial Levels	- .19	.070	+ .31	.002

r_s Kendall Correlation Coefficient

coverage at AL's in these organisations: it is not strong enough to be statistically significant (see Table (5.10)).

3. Consistent with (1) and (2) (above), it would be expected to be found that there is a good deal of accounting/financial bias in audits of AL's. It seems that non-accountant specialists are not having their corresponding share in audits of AL's since they are a minority in most internal audit departments (see: Tables (4.19) and (4.20)). However, since accounting/financial auditing is of a greater interest to AL's than operational auditing, it seems reasonable to conclude that whether or not audit departments have non-accountant specialists may not actually effect the extent to which AL's are subjected to internal audits.
4. With reference to the levels of management below administrative levels, there exists a degree of negative association between the number of accountants who are employed as auditors in the organisations responding and the frequency of audit coverage at both executive and lower managerial levels in these organisations ($r_s = -.20$ for EL and $-.19$ for LML. Both results are statistically significant at .95 level of confidence, see: Table (5.10)).
5. As against this, the Kendal correlation coefficient has resulted in slightly higher and *positive* degrees

of association between the number of *non-accountants* who are employed as auditors in the organisations responding and the frequency of audit coverage at both *executive* and *lower managerial* levels in these organisations ($r_s = .24$ for EL, and $.31$ for LML. Both results are statistically significant at the .95 level of confidence, see: Table (5.10).

6. In accord with (4) and (5) (above), the negative sign attached to the relationship between the number of accountants who are employed as auditors and the frequency of audit coverage at both executive and lower managerial levels does not mean that internal auditors with accounting/financial background or experience are having less participation in audits of these levels. In point of fact, they have always been there to conduct accounting and financial audits and they are also attempting to familiarise themselves with non-accounting and non-financial audits.

However, because audits of non-financial "operational" areas are of special interest to EL's, it appears that internal audit's attempts to cope with reviewing the tasks of EL's have been more successful when new disciplines have entered the field of the internal auditing profession.

The positive sign attached to the correlation between the number of non-accountants who are employed as auditors in the organisations responding and the frequency of audit coverage at both executive and

lower managerial levels in these organisations supports this interpretation.

7. In conclusion, any use of non-accountant specialists by internal audit suggests that internal audit would be better able to extend its scope into operational areas. This does not alter the fact that accountant internal auditors are still playing the main role in reviewing tasks of AL's and LML's to whom accounting/ financial auditing is of a greater interest.

CHAPTER 6

THE NATURE OF THE INTERNAL AUDIT APPRAISAL

Internal auditing is generally considered to be an independent appraisal function. Internal auditors as well as all other interested parties have accepted that description without undue question. However, there is only surface agreement as to the function of internal auditing because there is disagreement - the literature would suggest - as to what the term "appraisal" encompasses.

The empirical evidence reported in Chapter 4 has indicated that the scope of internal audit coverage and the type of emphasis has shifted to the more operational areas. This is further supported by the empirical evidence reported in Chapter 5 which indicates that internal auditors have also been able to go upward in the organisational hierarchy to audit tasks of management levels above that of the lower managerial level.

This chapter is concerned with the analysis and interpretation of the nature and extent of the internal audit appraisal activity and the problems which might be faced by internal auditors in audits of various operational areas and different management levels in line with what actually happens in practice.

6.1 What is Appraised?

As an aid to answering this question the investigation of this research area began with the following assumptions.

Internal auditing attempts to confine its work to appraising the efficiency of management control systems as:

- (i) this is the nature of the accepted audit task, and
- (ii) this helps to avoid alienating internal audit from management (see: Sec. 2.6).

To test this assumption, it was desirable first of all to evaluate the attitude of internal auditors toward appraising *the quality of management itself*.

Accordingly, audit managers were asked to indicate their opinion concerning whether appraising the quality of performance in carrying out assigned responsibilities should have a place within internal audit. If the answer were "Yes", the respondent was requested to indicate the extent to which each management level within the organisation should be subjected to such an appraisal (see: Q.9(a) and (b) in Appendix (B)).

The responses to this question are tabulated in Tables (6.1) and (6.2).

Table (6.1)
Attitude of Internal Auditors Toward Appraising
the Quality of Management Performance

Scale	Replies	NVC	Pct.
1	YES	35	73
0	NO	13	27
		48	100
Mean: .745 S.D.: .441 .95 C.I. .62 to .87			

Table (6.2)

The Desired Extent of Appraising the Quality of Management Performance
at each Management Level, as Expressed by Internal Auditors

Scale	Should be appraised	Levels of Management								
		Administrative			Executive			Lower Management		
		Pct.	Adj.Pct.	Cum.Pct.	Pct.	Adj.Pct.	Cum.Pct.	Pct.	Adj.Pct.	Cum.Pct.
5	Always	17	23	23	31	43	43	44	60	60
4	Mostly	-	-	23	8	11	54	8	11	71
3	Often	12	17	40	17	23	77	17	23	94
2	Sometimes	21	29	69	15	20	97	4	6	100
1	Seldom	6	8	77	2	3	100	-	-	
0	Never	17	23	100	-	-		-	-	
-1	*No Answer	27	Missing	27	27	Missing		27	Missing	
		100	100		100	100		100	100	
NVC = 48		Mean: 2.31 .95 C.I. S.D.: 1.79 1.70 to 2.93			Mean: 3.71 .95 C.I. S.D.: 1.30 3.27 to 4.16			Mean: 4.26 .95 C.I. S.D.: 1.01 3.91 to 4.61		

*Refers to those who answered the original question negatively, see Table (6.1).

Table (6.1) shows that 73% of audit managers replied in the affirmative, whereas only 27% of them answered in the negative. The computation at ".95 level of confidence" has resulted in a .62 to .87 confidence interval for the population average which indicates the existence of a strong desirability on the part of internal auditors to appraise the quality of management performance in general.

It seems, however, that the degree of this desirability varies when it comes to the organisational *level* at which the audit appraisal should be made. As shown in Table (6.2), all respondents indicated the desirability of subjecting executive and lower managerial levels to an appraisal of the quality of performance. As to administrative levels, this was expressed by only 77% of the respondents. Table (6.2) also shows that the extent to which an appraisal of individual performance should be conducted increases significantly when the level of management being appraised is a lower level in the organisational hierarchy. This is further supported by the information from the calculations at ".95 level of confidence" which have produced confidence intervals ranging from '*seldom*' to '*sometimes*' for administrative levels, '*often*' to '*mostly*' for executive levels and '*nearly always*' for lower managerial levels (see Table (6.2)).

Accordingly, the internal auditors' message seems to be that the higher they propose to go in the organisational hierarchy to appraise the quality of management

performance, the less expectation they have of acceptance. And this is particularly true as far as the internal auditor's appraisal of administrative levels is concerned.

The following comment provided by the audit manager in a large organisation sums it up:

"We appraise the quality of performance of all management at operating companies, but do not cover the performance of Group Directors. I nevertheless see no reason why they should not also be subject to such an appraisal."

But another audit manager in a large organisation commented that:

"We find divisional objection to (auditing the performance of administrative levels)."

6.2 The scope of appraisal

An additional insight into the nature of internal audit appraisal can be revealed through an investigation of the various audit modes or styles which indicate the direction and extent of audit work undertaken in organisations. Based on the literature, three internal audit modes were identified as being the main internal audit methods of approach in use. They are broadly defined as functional mode, departmental mode, and management studies (see: Q.13 in Appendix (B)) - see also Sec. 1.5.1. These audit modes were introduced to audit managers to determine (i) the frequency with which each of these modes is followed in their audit activities, and (ii) to glean information indicating the degree of emphasis placed on, on the one hand, appraising the efficiency of management control systems

and, on the other hand, appraising the quality of management themselves as individuals.

A detailed analysis of the responses to this question is presented in Tables (6.3), (6.4), and (6.5). Based on the data in these, it appears that internal auditors are in a position where they can define the scope of their review and the extent of their appraisal activity as they wish. Apparently, however, the tendency is to approach the internal audit work from the standpoint of the functional mode. As Table (6.3) shows, 98% of the audit departments use this mode in approaching their audit activities. Also, the calculation at ".95 level of confidence" has produced a 2.03 to 2.73 confidence interval which suggests that the functional mode is *extensively* used in practice (see: Sec. 4.3).

Nevertheless, Table (6.4) indicates that departmental mode also appears to be followed - in 94% of audit departments. Yet, the computation at ".95 level of confidence" has resulted in a 1.9 to 2.4 confidence interval which suggests that departmental audits are having a *moderate* to *extensive* usage among internal audit departments.

Management studies as an internal audit method of approach seems to be used in 88% of audit departments but the statistical measure of reliability has indicated a *moderate* usage for this audit mode between internal audit departments (see: Table (6.5)). This is understandable since such an audit mode will have a

Table (6.3)

The Frequency with which the Functional Mode is Followed in Practice

Description	Scale	Frequency of Use	NVC	Pct.	Cum.Pct.
<p><u>Functional Mode</u>: a functional mode is confined to one subject or process, it may cut across organisational lines and literally follows the function wherever it is performed throughout the organisation.*</p> <p>Functional audits tend to concentrate more on operations and processes than on administration or people.</p>		<u>YES</u>			
	3	Extensive	24	50	50
	2	Moderate	19	40	90
	1	Little	4	8	98
	0	<u>NO</u>	1	2	100
			48	100	
	Mean: 2.38 S.D.: 1.25 .95 C.I. 2.03 to 2.73				

*Examples would be the audit of the launching of a new product, or the security audit.

Table (6.4)

The Frequency with which the Departmental Mode is Followed in Practice

Description	Scale	Frequency of Use	NVC	Pct.	Cum.Pct.
<p><u>Departmental Mode</u>: a departmental audit selects for review all activities in the control of a given managerial position and may therefore involve a review of several unlike subjects.</p> <p>Departmental audits tend to concentrate more on administrative controls and people rather than on processes flowing through the organisation.</p>		<u>YES</u>			
	3	Extensive	23	48	48
	2	Moderate	14	29	77
	1	Little	9	19	96
	0	<u>NO</u>	2	4	100
			48	100	
Mean: 2.21 S.D.: .898 .95 C.I. 1.90 to 2.40					

Table (6.5)

The Frequency with which the Management Studies Mode is Followed in Practice

Description	Scale	Frequency of Use	NVC	Pct.	Cum.Pct.
<u>Management Studies</u> : when a top-notch internal audit team participates in special studies involving making an evaluation of, and offering recommendations for improvements in, problem areas of the business.		<u>YES</u>			
	3	Extensive	10	21	21
	2	Moderate	20	42	63
	1	Little	12	25	88
	0	<u>NO</u>	6	12	100
			48	100	
	Mean: 1.75 S.D.: .920 .95 C.I. 1.48 to 2.02				

a defined scope which is often determined by the specific request of management and/or the specific audit research that the internal auditor has set for himself.

In conclusion, the above analysis and discussion suggest that the activities under review can be broken down in any way desired as a basis for establishing what is wanted in the way of the internal auditor's work. Hence, in the last analysis the scope of a particular review is determined by a combination of what management generally wants and what is manageable from the standpoint of the internal auditor. Within these boundaries, however, internal auditors are more likely to approach their reviews from a standpoint which concentrates more upon management control systems by which the operations and processes are governed than upon the people who are doing the managing.

This conclusion is further supported by the information deduced from comments provided by audit managers to another question (see: Q.14 in Appendix (B)). In this question, audit managers were requested to provide a brief description of the audit modes which indicate the direction or scope of audit work undertaken in their organisations. Examples taken from their replies may be cited as follows:

1. Free approach - all audit modes are in use.

"Our policy is to use whichever mode of audit is best suited to the subject matter, e.g.

Functional mode for the UK Group has been used for:
V.A.T., supplies procedure, and working capital.

Functional mode for an operating division has been used for Order Execution Procedures.

Departmental mode has been used for other internal audits."

* * * *

"All audit modes in Q.13 are used extensively, in their place. One generally considers the Functional Mode, say "Purchasing". If corporate divisions are many miles apart, one generally audits on a Departmental Mode basis while at that location, covering a number of functions at the divisions, so that minimize travel time and expense.

Management studies are at times required, to cover problem areas of the business, at the request of management; these should not comprise a large part of the audit program or the Internal Auditor loses his independence - to look where he feels the greatest necessity exists."

2. Free approach - in favour of functional mode

"Under difficult environmental conditions it is not easy to maintain a streamed activity.

However, in our trouble-shooting activity we tend to concentrate more on a functional mode which, in my view, gives a quite clear insight into the effectiveness of both management systems and the people behind the process."

3. Free approach - in favour of departmental mode

"Our Group allows us freedom to look at any area of the operating companies' activities. Thus we adopt whatever audit modes we consider appropriate at each company, although our experience so far has tended to be a 'departmental mode' approach more than any other."

6.3 The relative emphasis of audit work with respect to appraisal of management systems and appraisal of individual performance

Up to this stage, the discussion has dealt with audit managers' opinions concerning the question of whether

appraising the quality of performance in carrying out assigned responsibilities should have a place within the internal audit work with reference to the various management levels (Sec. 6.1). Further reference to the same question has been made through an investigation of the various ways of determining the scope and extent of the internal audit appraisal activity (Sec. 6.2). Now, it is intended to investigate the nature of the internal audit appraisal activity through the visible end-product of an internal audit service within the organisation - that is the internal audit report.

The purpose of this investigation is, first, to determine the levels of management whose work is actually affected by the internal audit points (i.e. recommendations) made and, second, to determine the proportion of audit points which (a) directly (b) by implication, comment on the quality of management rather than (c) on the efficiency of management control systems. Results on these are reported hereunder.

This investigation was also supplemented by in-depth interviews with audit managers and other managers outside the internal audit function to learn their views and attitudes in this respect. The outcome of these interviews is reported under Sec. 6.4 et seq.

Table (6.6) discloses data concerning the examination of audit reports, and based on them the following conclusions seem appropriate.

1. Internal auditors appear quite definite that their audit activities are mainly concerned with the review and appraisal of the efficiency of management control systems, not of the quality of individuals doing the managing. This is supported by the fact that 81% of the total number of audit points made to management in the organisations responding in this phase of the study directly comment on management controls and, only 19% of audit points made comment, in most instances by implication, on the quality of individual performance in related audit areas.
This is in line with what is generally considered to be the nature of the internal audit task (see: Sec. 6.1).
2. As the investigation of audit reports revealed, it must be pointed out that the appraisal of individual performance is mainly limited to an evaluation of particular management members within an organisational unit and does not cover the overall quality of management members who are responsible for the managing of that particular organisational unit.
When an appraisal of the overall performance of an organisational unit is carried out, this is mainly based on the appraisal of the efficiency of management control systems by which the operations of this particular organisational unit are governed and, the auditor's conclusions and findings are used as an indirect indication of the quality of management performance in that unit.

Table (6.6)

Analysis of the Topics of Audit Reports, with Reference to Management Levels and Types of Appraisal carried out

Levels of Management being Appraised	The number and proportion of audit points made				Total	
	Types of appraisal					
	Management Controls		Individual Performance		Number	Pct.
	Number	Pct.	Number	Pct.		
Administrative Levels	254	10	-	-	254	10
Executive Levels	795	87	119	13	914	36
Lower Managerial Levels	1000	73	370	27	1370	54
Total	2049	81	489	19	2538	100

As an example of this latter point, the following quotation taken from an audit report is representative:

"The systems operated within the ABC company are efficient and well organised. There were no areas where specific recommendations could be made and management appears to be sufficiently in command to adopt new procedures when necessary." (see also 3(a) hereafter)

3. As we move towards the level of management at which the audit appraisal is conducted, data in Table (6.6) shows the following:

(a) All audit points which relate to administrative levels are mainly concerned with administrative levels of *subsidiary* companies and are basically based on reviews and appraisals of management control systems employed in these subsidiaries. Most of audit points made which affect these higher levels, are in connection with the accounting and financial aspects of related areas (see: Table (5.5)).

Not one single audit recommendation was made which commented on the quality of individual performance at these higher levels. In only one case, in which a special audit investigation was carried out to report on some irregularities discovered during the course of the audit, was there an audit comment which concerned individual performance at these top levels. The following quotation taken from an audit report highlights this exceptional case:

"From our review we have formed the opinion that the arrangements made by management for internal control in the companies visited have been in general suitable for the needs of the business and have operated satisfactorily.

However, we have drawn attention to a number of important matters requiring attention, two of which are mentioned below.

- (1) During the first half of 19XX, the Managing Director of R. Ltd., a XYZ subsidiary, was involved in unauthorised trading in the ... market. He incurred an uncovered position ten times in excess of the level to which he was authorised. ... The Managing Director responsible has now resigned.

Given the complexity of the XYZ accounting systems and the degree of responsibility delegated to the Managing Directors of merchant companies, we consider the full-time employment of XYZ's own internal auditor would serve as an important control over the business. His visits could in our view provide a significant safeguard against irregularities of the kind incurred at R. Ltd. ... Management has stated that the Company's own internal audit function has now recommenced operations.

(2)"

- (b) At executive levels, Table (6.6) also indicates that the internal audit appraisal activity appears to be largely directed to an evaluation of management controls rather than to individual performance at these levels. 87% of the total number of audit points made which affected these levels commented on the efficiency of management controls whereas 13% were concerned with the quality of individual performance.

Recalling the earlier results reported in Chapter 4 (see: Table (4.6) item 5), it appears that the 72.9% of audit departments which stated individual performance is appraised (in the context of an evaluation of overall performance of various operating departments within their organisations) was an overstatement. Probably, individual performance is implicitly appraised but no direct mention of it is indicated in the audit report. As an illustration on this last point, the following quotation taken from an audit memorandum is representative. Based on this review of an operating company, the auditor in charge wrote to the chief internal auditor:

"Internal Audit have recently completed checks on the office equipment inventory and our report on this activity was included in However, there were two particular cases affecting Marketing Personnel which were distinctly unsatisfactory and I'm advising you of the following additional points *rather than including them in the formal report* (italics ours).

We had a special early morning meeting with Retail Marketing Director to discuss these matters, and we offered to take them up to get what recovery we could from these situations, but the RMD asked us to leave the matter generally with him for his attention."

- (c) (i) At lower managerial levels the appraisal of individual performance appears to be more tenable than at any other level. Table (6.6) shows that 27% of the total number of audit

points which affected lower managerial level were associated with the appraisal of individual performance at these levels. However, this does not alter the fact that 73% of audit points made which affected these lower levels were based on reviews of the efficiency of management control systems.

(ii) Since most internal auditors are trained in accounting and finance - see Table (4.19) and (4.20) - they generally appraise the competence of the accounting staff in their organisations. One evidence of this interest may be found in the following quotation taken from an audit report:

"In our opinion, there is a need to strengthen the accounting function within the company to enable a satisfactory level of control to be maintained. ... Since most branch managers have little accounting experience, we believe that in addition to strengthening the central accounting control, there is also a need to improve the accounting expertise at branches. This might be done by additional training and more frequent visits by experience staff."

In some instances, the internal audit appraisal of individual accounting staff is made by commenting directly on the manager in charge as the following quotation taken from an audit report discloses:

"... Most of the company's basic systems and controls appear adequate, although we found that the purchasing and cash payments functions required considerable tightening up."

"... .. In our opinion, ... does good work in his present capacity as accountant at ..., but he tends to do things his own way and we doubt that he will be able to shoulder any additional load under the large set-up.

We recommend the appointment of a well qualified accountant who can concentrate on improving the quality and accuracy of management reporting and preparing for the eventual computerisation of accounting systems to match the physical operations of the company."

4. In conclusion, the foregoing analysis and discussion suggest the following:

- (a) In carrying out their appraisal activity, internal auditors attempt to confine themselves to appraising the efficiency of management control systems rather than evaluating the quality of performance in carrying out assigned responsibilities.
- (b) Sometimes, however, internal auditors do extend the scope of their appraisal activity to include the appraisal of individual performance. In doing so, it is the quality of particular management members that is appraised not the quality of management in charge of an operating unit in general. If the latter kind of appraisal is carried out, it is done through an evaluation of the efficiency of management systems employed in that operating unit and the end-results of such evaluations are often considered to be an implicit indication of the quality of management performance of that particular operating unit in general.

- (c) Since most internal auditors as well as the vast majority of the internal audit leadership have accounting/financial background and experience, they generally evaluate the competence and individual performance of the accounting staff in their organisations - see: Sec. 4.6.3.

What does that leave us with? The whys and wherefores - that is the need for causal explanations indicating why internal auditors cannot and/or should not be involved in the appraisal of management performance? A matter that will be dealt with further in the following section.

6.4 The role of the internal auditor in resolving the problems of the control cycle

The foregoing discussion has dealt mainly with the two key elements of the concept of "appraisal":

- (a) appraisal of management controls systems and/or
- (b) extending the appraisal of controls to include individual performance.

However, "quality of performance" could be interpreted in a depersonalised way. In addition to the two key elements referred to above, appraising the quality of management performance includes in more broader sense the appraisal of management decisions. The review of technical performance can also not be ignored within such a broader interpretation of the term "appraisal".

It was desirable, therefore, to bring this issue into the open with audit managers during the interviews (see: Q.1 in audit managers' interview schedule - Appendix (D)).

The issue of appraising performance was defined and introduced to the interviewees as follows:

The accounting and financial control areas were the original concern of the internal auditor and continue to be a major area of interest.

Now, the internal auditor extends the scope of his appraisal activity to other types of operations seeking for more efficiency and greater profitability in the broadest sense.

This upward thrust in all operational areas to such larger issues means involvement at higher and higher managerial levels. Here the road becomes increasingly difficult and the question is often raised as to what extent the internal auditor is able to go in terms of the scope of his review and appraisal to contribute constructively to the managers who are responsible for managing the business?

Responses and views concerning this question are presented hereafter in terms of the nature of the problems which face management in the control process (see: (2) et seq in Appendix (F)).

6.4.1 Firstly: Problems of Choice

Based on the interviews, the main limitations which have a direct impact on the scope of the internal auditor's appraisal activity in dealing with this aspect of the control process (see (2) in Appendix (F)) were found to be:

- (a) Lack of acceptance due to negative attitudes of management.
- (b) Lack of an established body of standards for the evaluation of managerial abilities and performance concerning management decisions.
- (c) A charge that the internal auditor lacks the necessary competence which enables him to make an authoritative appraisal in this respect.

Examples of opinions given on this subject may be cited as follows:-

"I personally think an evaluation of management decisions should be made as this is where I see the future of internal audit. However difficulty is experienced selling the ideas."

* * * *

"No main Board encouragement for the internal audit department to become involved in such activity."

* * * *

"To be effective, the internal auditor must be able to provide tools of analysis by which management can decide and act with knowledge of the implications of each situation. There are many business situations where it is not easy for the internal auditor to give verdict as to the effectiveness of specific decisions."

(This last interviewee refers to the difficulties of defining generally accepted criteria for appraising the soundness of management decisions and the possibility that the internal auditor may lack the necessary competence to deal effectively with the appraisal of such managerial activities).

* * * *

"In my opinion, the internal auditor must learn to think like management, but it is also necessary for him to know that he is not the manager responsible for making decisions. Sometimes with the benefit of hindsight the auditor might see that a different decision would have been a better one for the company. In this case he might be able to evaluate how good that decision was on an "ex post facto" basis and report therefrom to top management to decide whatever action is needed."

6.4.2 Secondly: Problems of Adjustment

Turning to the problems of the adjustment of existing situations which might face management in the control process, we find a relatively wide room for the internal

auditor to offer contributions to his organisation by utilising and extending the internal audit role as a general source of information (i.e. feed-back process).

Although this type of internal audit service concerns all management levels, it is particularly relevant in two situations. First, when administrative levels utilise the feed-back information arising out of specific reviews to rationalise management decision models (i.e. when policies, plans, etc., are revised or made void). Secondly, when the review involves operations at locations not easily accessible to higher management personnel. Here, the internal auditor serves as a supplementary source of information to bridge the organisational and geographical gap in the organisation (see: p.191 and p.226). Indeed internal auditing has recently been defined by Unilever as the review of the information flow to the monitoring process of a system for its quality and completeness⁽¹⁾: this means that it is seen as providing reassurance to management that the information which is being fed to management for control purposes is accurate, complete, reliable and not misleading.

In discussing this issue with the interviewees, two important notes were emphasised. First, the internal audit role in this feedback process is mainly concerned with providing information as to how effective the control

1 Graham, M.E.G., "Boundaries of Internal Auditing", (London: Internal Audit Seminar, ICAEW, October 10, 1978).

systems are coupled with the auditor's recommendations concerning what might be done to improve them. Secondly, the audit findings and recommendations for improvement are based on the appraisal of the efficiency of management control systems that are in operation, not on an assessment of the individual doing the managing process. When reported to higher management levels, the audit points made might help administrative levels in dealing with the problems of adjustment and, in turn, these audit recommendations might influence management decisions on adjusting or changing the decision models employed.

Higher management levels appreciate the internal audit service in this respect because the internal auditor extends their knowledge by reporting details and evidence supporting a decision concerning the efficiency of management controls employed within the organisation.

The practical evidence reported earlier in this study (see: Sec. 5.3.2) has indicated that higher management's appreciation of this type of internal audit service (i.e. feed-back process) tends to increase with the increased size of an organisation. Here, the value of internal audit feedback as perceived by executive managers is acknowledged in so far as the information reported to higher management levels relates to the quality of management's systems. In support of this, executive managers were requested to indicate their opinion concerning the following statement:

"Internal audit reports provide a feedback of information to higher management levels as to the quality of management's systems."
 (see: Q.6(iii) Appendix (C)).

Table (6.7) displays their replies.

Table (6.7)

The value of internal audit feedback as perceived by executive managers

Scale	Type of agreement	NVC	Pct.
1	Agree	20	95
2	Uncertain	1	5
3	Disagree	-	-
		21	100

Mean: 1.048 S.D.: .218 .95 C.I. .95 to 1.15

The data reported in Table (6.7) suggests that most (95%) executive managers in the organisations responding believed that internal audit serves as a general source of information and this is especially true when the information concerns the quality of management systems. It is interesting to note that the calculation at ".95 level of confidence" has resulted in a .95 to 1.15 confidence interval which means that the average of the population responses as to the implication of the statement shown in Table (6.7) falls nearly within the range of complete agreement and, thus, the internal audit role in this respect is highly appreciated by management.

6.4.3 Thirdly: Problems of Action

As pointed out earlier, problems of action reside to a large extent within the sphere of executive and lower managerial levels. It is also reported that most internal audit work is concerned mainly with the activities of executive and lower managerial levels (see: Sec. 5.1.2.). Here, it is intended to see to what extent the internal auditor is able to contribute to the managers responsible for operational areas and the nature of his service provided at these levels.

Generally speaking, problems of action represent problems of setting certain means of action (i.e. means of authorisation) and the controlling factor in this context will be the efficiency with which management decision models (i.e. policies, plans, etc.) are executed in a manner which can best achieve the objectives. Consequently, the first necessity for the internal auditor's appraisal is to ascertain the extent of *compliance* with established policies, plans, and procedures.

In his work on compliance, for example, the internal auditor's appraisal activity will be concerned with focusing attention on standards of action and variances therefrom, and this includes the probing for cause of those variances and the appraisal of their significance. To this extent, the auditor's appraisal will encompass recommendations for such corrective action as will reduce non-compliance in the future, as this will best serve the organisation's interest.

In audits of compliance which relate to routine situations and/or which are based on accounting/financial criteria the internal auditor's appraisal activity is relatively simple. Here, the internal auditor's competence is not seriously challenged. The practical evidence reported in this study (see: Sec. 4.3 et seq) as well as other empirical studies supports this view.

On the other hand, the term "appraisal" suggests that the internal auditor is interested in changes that would result in improvements in the way operational actions are carried out. Thus, the internal auditor's appraisal will be more constructive when it is indicated that changes in underlying policies or procedures are what are really needed. In this respect, internal auditing seems to be as successful at modifying policies as it is in modifying procedures by which the responsibilities of executive and lower managerial levels are governed and carried out. And the internal auditor's effort in this area is highly appreciated by executive managers. The practical evidence cited under Sec. 4.3 and 4.4 supports this view.

Yet, the internal auditor's appraisal activity will be constructive in a more positive sense when the audit findings indicate that sub-objectives (i.e. those assigned to each operational unit) themselves need modification so as to better achieve overall objective(s) of the organisation. The concern now is with how *efficiently* and *effectively* the action phase is carried out. This phase of audit appraisal includes:

- (i) appraisal of the overall efficiency and performance of the particular operating unit (i.e. achieving its objective with the lowest consumption of resources).
- (ii) appraisal of the effectiveness of each separate operating unit - that is, the extent to which an operating unit achieves its objective in conformity with the overall objective(s) of the organisation - see: (8) in Appendix (F).

With respect to (i) and (ii) (above), the practical evidence reported earlier in this study (see: 4.3 et seq) has indicated that most internal audit departments participating in the study are involved in the evaluation of overall performance of various operating departments in their organisations. A follow-up of this point during in-depth examination of the topics of audit reports indicated that in this type of internal audit, internal auditors place much more emphasis upon (a) the efficiency of controls as specified by the procedures relating to methods of operation and (b) the safeguarding of assets. This also includes a detection of possible sources of waste and a feedback of information on the cost efficiency of work done, in addition to ascertaining the extent of adherence to laid down policies, plans, and accounting and financial criteria.

In conclusion, the internal auditors's effort in this area is mainly based on an approach which limits itself to an appraisal of control-in-the-small and efficiency

rather than the appraisal of control-in-the-large and effectiveness. They are still performing this type of audit appraisal with an accounting and financial bias and are basically interested in cost efficiency per se. This limited approach reduces the total effectiveness of the internal audit function and prevents the internal auditor from being of maximum usefulness to the organisation.

This conclusion can be further illustrated by setting out some examples taken from audit reports as follows:

"In our opinion, certain of the management information currently available does not provide a sound basis for assessing the viability of individual activities or branch operations as a whole. There are inconsistencies in that the data which is prepared and revenue and direct costs are not allocated so as to identify the contributions arising from the distinct types of business carried out.

Management acknowledge that improvement is necessary and they are currently considering the appointment of a Commercial Manager to strengthen the establishment."

* * * *

"This audit has disclosed a very serious state of affairs at ... Branch. We noted so many weaknesses and flaws in procedures that considerable effort will be needed to put this Branch on a sound footing. We made reference in our previous audit report and would again stress that further improvements in control are required. We recommend that this Branch be given management's attention."

* * * *

"A standard Credit Policy for XYZ companies was approved in 19XX. In certain of the companies we visited, several important aspects of the policy were not yet fully operational. In view of present trading conditions within the ... industry, we consider it important that urgent attention be paid to the full implementation of this policy in all XYZ companies."

As an additional insight into the extent of the internal audit appraisal activity, it is interesting to note that in the I.I.A., Research Report No.19, the respondents were requested to indicate both the current nature and the desired nature of operational audits with reference to the managerial activities being reviewed. Table (6.8) shows the responses to this question. In accordance with Table (6.8), if an operational audit is being performed, it seems that most internal audit appraisal will be concerned with an evaluation of management controls rather than an evaluation of management decisions or management quality.

The ratios shown in Table (6.8) indicate universal acceptance of appraisal of management controls whereas there seems to be a reservation for internal auditing to be involved in evaluating management decisions and reservations increase when management quality is subjected to audit appraisal. Nevertheless, the comparison between the current extent and the desired extent of evaluation suggests that such managerial activities represent possible areas of internal audit work in which the internal auditors are expected to render every possible assistance that will facilitate the progress of the organisation.

These results are consistent with the finding of this study - Chapters 4 and 5. Yet, with particular reference to the issue of evaluating management decisions, the I.I.A. research indicated that some respondents who are not evaluating decisions stated that such evaluation

"represents the use of hindsight to second guess the manager and creates management opposition".⁽²⁾ Another stated reason for not evaluating the decisions was that "the manager is influence by internal, political considerations or relationships that he must consider in making decisions that motivate him to exercise his prerogative of not necessarily always complying with the particular control system."⁽³⁾ Yet a third reason was that "the lack of the required technical ability on the part of the auditor."⁽⁴⁾

Table (6.8)*

The Nature of the Auditor's Evaluation

Managerial Activity	Currently Evaluated	Should be Evaluated
	%	%
Management Controls	98	90
Management Decisions	60	66
Management Quality	51	65

* Source: the I.I.A., Research Report No.19, 1975

Special appraisal problems for internal auditors

The foregoing discussion and explanations indicate that, in the area of appraising performance, there is a great potential opportunity for the internal auditor to

2 The I.I.A. (5), op.cit., pp.19-21.

3 Idem.

4 Idem.

provide a service to the organisation. In practice, however, two problem areas in particular have frequently been encountered in achieving these potentials, namely the review of personnel themselves and secondly, the review of technical performance.

The former represents the subject matter of the following subsection, the latter will be dealt with under the next subsection in this discussion (see: 6.4.5).

6.4.4 The review of individual performance

The benefits of an internal audit service in the area of appraising personnel performance can be said to represent a payoff between two contradictory factors.

On the one hand, the quality of individual performance involves a great number of complicated factors which are far more subjective than most of those conventionally included in other audit areas and, since it directly concerns human beings as individuals it can easily become extremely sensitive.

The case against audit involvement in this area is more likely to be couched in the terms that internal auditors lack the necessary competence to enable them to carry out beneficial and reasonably authoritative appraisals of personnel performance.

On the other hand, the challenge which exists in most operational situations is to find a balance. In this context, what is increasingly clear is that the proper identification of personnel performance is at the heart of the efficiency and effectiveness of the total control

effort. And as he is the control specialist, the internal auditor should push the control function into new aspects of operations by a more capable analysis of the pertinent factors one of which surely is the review of personnel performance.

Why then are internal auditors reluctant to appraise the quality of management as individuals themselves? The practical evidence reported earlier in this chapter (see: Sec. 6.3 et seq) is directly related to this issue. Here, the discussion will be focussed on related causal explanations provided during the interviews with audit managers as well as other management perception of the internal audit role in this respect.

Based upon the interviews, the following opinions and views were expressed.

"I personally believe one must carefully distinguish between the systems themselves and the individuals who operate them. However, we generally evaluate the quality of personnel performance of the subsidiary companies in so far as they apply to financial and accounting controls, including profitability."

* * * *

"Evaluation of individual performance includes many complicated and subjective factors and since it concerns people it can easily lead to very touchy situations. We find management opposition to this."

* * * *

"This is done (i.e. the evaluation process) through reviews of compliance with established financial criteria, moving towards operational auditing with an emphasis on profit performance."

* * * *

"We evaluate the efficiency of operations and when deficiencies are found, we try to identify causes in terms of weaknesses in the systems of management control."

* * * *

"It is not that they (internal auditors) consider that managers themselves are not components of the control system: of course they are. The reason is that the internal auditor feels that his job would be made impossible if he became a critic of managers who are the people that he is there to serve. Accordingly, the conventional wisdom of internal auditing is to set limits for the operational audit which exclude an evaluation of the quality of management themselves not because the management themselves are irrelevant from a control point of view but because the internal auditor's role makes it very difficult for the internal auditor to be the person who conducts the evaluation of management themselves. It can be argued that this reduces the value of the internal audit service in the area of operational auditing since the internal auditor is not looking at all aspects of the operations."(5)

* * * *

These explanations are generally consistent with those reported earlier (see: 6.3 et seq), but they do highlight two important notes:

1. There is a possibility that some other staff group within the organisation might be very much concerned with the appraisal of personnel performance. For instance, in the U.K. Civil Service this group is the Staff Inspectorate. Or, such an appraisal is considered to be a part of the basic responsibilities of the line managers who are in charge of operations and, when the need arises, the internal auditor will

5 Chambers, A.D. (7), loc. cit.

be called in to carry out his role in the evaluation process as the agent or the advisor of the line managers.

The practical evidence cited under 6.4.4.1 casts more light on this. . . .

2. It is again recognised that when the internal auditor concerns himself with the more basic operational activities involving accounting and finance, he more generally has both the competence and acceptance that enable him to make a useful and reasonably authoritative appraisal of personnel performance. This may have been a consequence of most of internal auditors being qualified accountants. But does this mean that an audit department which is staffed with other non-accountant specialists would be better able to deal with all aspects of operational areas being reviewed, including the appraisal of personnel?

The practical evidence cited under Sec. 5.3.3 indicates an affirmative answer to this question.

6.4.4.1 Management's perception of the internal auditor's role in appraising performance

Perhaps, the actual extent of the internal audit role in appraising the quality of management performance can be perceived more clearly when it is indicated by the people who would be subjected to such appraisal.

Executive managers were asked (see: Q.7 in

Appendix (C)) to indicate whether there exists a management system employed in their organisations to evaluate the quality of their performance in carrying out assigned responsibilities. If the answer were "Yes", the respondent was requested to indicate to what extent the internal audit department of his organisation had the responsibility to carry out the evaluation process. Their responses are shown in Table (6.9).

Based on the data in Table (6.9), management is generally aware of the benefits of appraising the quality of personnel performance. 71% of executive managers responding indicated that there is a management system employed in their organisations to evaluate the quality of their performance. Despite this, among those who answered in the affirmative to this question, some 73% reported that internal audit departments of their organisations have no responsibility in carrying out the evaluation process, whereas 27% stated that their audit departments are partly responsible in this respect.

Add to this the 29% who stated that there is no management system employed in their organisations to cover this ground, and it does not take much effort to conclude that the internal audit role in the evaluation process is very small indeed and, thus, management misses a good opportunity to utilise its internal auditors in an area where they could be useful to the organisation.

In conclusion, what seems to be the case is that managements tend to keep their internal audit departments

Table (6.9)

Internal Audit Role in the Evaluation Process
as Perceived by Executive Managers

1. Is there a management system employed in your organisation to evaluate the quality of your performance in carrying out assigned responsibilities?

Scale	Answer	NVC	Pct.
1	YES	15	71
0	NO	6	29
		21	100
Mean: .72 S.D.: .463 .95 C.I. .51 to .93			

2. If "YES", does the internal audit department of your organisation have the responsibility to carry out the evaluation process?

Scale	Answer	NVC	Pct.	Adj.Pct.
3	Complete Responsibility	-	-	-
2	Partial Responsibility	4	19	27
1	No Responsibility	11	52	73
0	Not Applicable	6	29	Missing*
		21	100	100
Mean: 1.27 S.D.: .46 .95 C.I. 1.02 to 1.52				

*Refers to those who answered "No" to the original question.

away from this rather sensitive area. This could be due to either a limited interpretation of the internal audit appraisal activity which excludes an evaluation of personnel performance or, for one reason or another, the role of internal auditors in this area is generally not appreciated by management members. Whatever the reason, evidently, this limited view reduces the value of the internal audit service in the area of operational auditing since the internal auditor is not looking at all aspects of the operations, nor at all components of the internal control system.

6.4.4.2 This conclusion is further supported by the information from executive managers who answered negatively to the original question shown in Table (6.9). They were requested to indicate how they evaluate their people's performance by giving examples of main standards which have been developed in their organisations to cover this ground and, the type of assistance received from the internal audit department in this respect (see: Q.7 in Appendix (C)). Probably, the best way to introduce their answers is to turn directly to their own comments among which the following are representative:

"Key tasks set by line Management assess the performance at staff appraisal.

The internal audit role: Nothing, but any key tasks covered by audit would influence line managements at staff appraisal."

(General Manager: responsible for
Planning & Administration)

* * * *

"By the comparison of annual performance against goals agreed in advance with the employee. Standards utilized include:

- Technical ability
- Management ability:
 - Planning, organising, delegation
 - Development/motivation of subordinates
 - Inter/intra departmental co-operation, and
 - Major accomplishment.

The internal audit role: Little

(Vice President and Deputy General Manager)

* * * *

"Monitoring performance against agreed objectives for output (physical terms) cost and revenue.

The internal audit role: Little, not directly. Internal audit is more operational systems oriented rather than the operations themselves."

(Divisional Director)

* * * *

- "- Against agreed objectives measured,
- Against audit comments received and action taken,
- By manpower audit routine (Committee of interfacing Managers with Department Managers assessing individual performance).

The internal audit role: Moderate."

(Comptroller - General Accounting)

* * * *

"We are still developing our techniques in this area.

The internal audit role: Moderate."

(Accountant Manager)

* * * *

"This is done by, observation, reports emanating from the internal audit department and the feedback from auditees and, normal staff annual reports by section, leaders, managers etc.

The internal audit role: Extensive."

(Director of Finance & Administration).

In accord with the above mentioned comments it can be recognised that, unless there is a management system employed in the organisation to evaluate the quality of performance in carrying out assigned responsibilities, most of managers responsible for key tasks have their own means to achieve the evaluation process in their operational areas. The internal audit share in the evaluation process tends to increase in the area of accounting and finance.

6.4.5 The review of technical performance

Should the internal auditor appraise the technical aspects of the operations being reviewed? This question is subject to some controversy. Based on the interviews, the basic justification for those executive managers who resist the internal audit role in this respect seems to boil down to the following:

The internal auditor cannot be an expert in all operational areas especially those of a highly sophisticated technical nature. Hence, his appraisal activity could be justified if he limited himself to the aspects of operations where he is reasonably on solid ground.

Should an auditor move beyond this range and enter into the area of judging the correctness of technical decisions, he will automatically be crossing the line between what is a question of judgement and what is a question of fact. The internal auditor cannot help

himself or his organisation if he attempts to measure the validity of technical judgements.

These are powerful arguments. But they must be considered with an open mind:

1. Since most internal auditors are accountants - see: Table (4.19) and (4.20), there is a necessity to recognise the limitations of the internal auditor in understanding what constitute good technical performance in such diverse operational areas as engineering, research, production, and the like. This points to the desirability of having audit staff composed of men with backgrounds in various areas of business. The practical evidence in this study (see: Sec. 5.3.3) suggests that when the audit staff is augmented with such non-accountant specialists, the ability of the internal audit department to get involved in auditing operational areas will certainly be extended beyond the accounting and financial aspects of the operations under review.
2. The fundamental question is, do the technical aspects of the operations under review have any bearing on whether or not management controls are functioning as intended? For the internal auditor, his competence in control matters represents a credential for entry into the different operational areas and a basis for constructive contributions to the managers responsible for these activities. By working in co-operation with those individuals who understand the exact nature of

the particular technical aspects of the operations, these contributions can be better achieved. The following comment provided by the audit manager in a large organisation highlights this view.

"In the areas covered by internal audit to date managers are very involved in the technical aspects of their role, therefore our aim is:

- (a) to generate an awareness of control matters within managers,
- (b) to link their technical expertise with systems improvement and development, and
- (c) to reduce managerial stress by minimising the effects of change."

It must be recognised, however, that the achievement of these contributions is not an easy task and, as indicated, internal audit work in this area may require the assistance of personnel trained in other professional fields such as engineering and research; yet, these contributions can be achieved by an internal auditor who is not an engineer or scientist, for instance. The following statement is a quotation in which the auditor wrote to the manager responsible for the quality control department:

"Internal Auditors are of course not competent to make specific quality tests for themselves but our programme will be designed to check that all relevant tests have been made and that the proper procedures as laid down have been followed."

A key to effective auditing in technical areas is to realise that technical aspects must be controlled by administrative systems. For instance, the auditor may not be competent to assess the technical competence and performance of individual scientists but he is

competent to assess that a system of conducting this assessment is (a) in existence, (b) is appropriate, (c) being complied with and (d) acted upon. In practice most audit work in technical areas is of this variety - i.e. administrative rather than technical. This does not obviate the case for technical specialists within the internal audit department: such specialists will undoubtedly be more at ease in technical audit situations than non-specialists. They will also be more acceptable to the auditees. In conclusion, it is in the organisation's interest that whatever contribution by the audit department can effectively be made, is actually made. The value of a review of technical performance by the internal audit department lies in the fact that there is a resource group in the company which is specially well positioned in terms of independence to extend its effort at relatively low cost to cover other areas of management interest.

CHAPTER 7

GENERAL FEATURES OF INTERNAL AUDITING SERVICES

References has previously been made to the functional areas in which internal auditing attempts to provide a service, and also to the managerial levels at which that service is provided. This chapter will be concerned with discussion of the nature of internal auditing services in terms of the extent to which they are *protective* audits and the extent to which they are *constructive*.

Protective internal auditing refers to auditing with the objective of maintaining things as they are supposed to be in terms of existing policies, plans, and procedures.

Constructive internal auditing is concerned both to evaluate and to improve existing company practices, and may involve audit recommendations which are designed to lead to more efficient, effective or economic methods, rather than merely commenting on the extent of compliance with laid down procedures as in a protective audit.

It is important to note that the pursuit of constructive internal auditing is closely related to both the review of controls and the appraisal of performance (see: Chapters 4, 5 and 6). Much that was said there in respect of both the functional area to be reviewed (i.e. financial versus non-financial aspects) and also the managerial level at which the review is made, is, therefore, directly applicable.

An analysis of the internal audit service in terms of whether it is protective or constructive, or both, may be approached from differing standpoints, viz:

- (i) The relative emphasis of audit work on:
 - (a) what has already happened (past management phases - i.e. historical auditing), and
 - (b) what is being planned (future management phases - i.e. pre-event auditing).
- (ii) The nature of internal audit points (i.e. audit findings and recommendations) made to management.

7.1 Firstly: The relative emphasis of audit work with respect to historical and pre-event audits

One of the main concerns of internal auditing is to avoid having a responsibility for the development of procedures, and then, later, to be subjecting those same procedures to an audit review.

Recently, however, there are some signs of compromise regarding this philosophy. The rationale is that the internal auditor has the experience and overview of broader operations which make his counsel very valuable to management. Admittedly, this participation as a consultant is a possible threat to the internal auditor's independence and objectivity in any subsequent review of the operation. However, "it is seen as more constructive to raise audit points at the design stage and is not considered to be prejudicial to the objectivity of subsequent audits."⁽¹⁾

From the standpoint of this study, it is believed that internal audit's involvement in the betterment type of approach (i.e. providing a constructive service) is in fact closely interrelated to providing an audit service which is also characterised as being protective in nature. An evaluation of internal audit's involvement in carrying out protective services is a suitable starting point for any meaningful evaluation of further audit services which can be viewed as being constructive in nature, and from

1 Chambers, A.D. (9), op.cit., p.181

this standpoint the following discussion and analysis will be developed.

7.1.1 Appraisal of existing systems

The practical evidence reported earlier in this study (see 6.1 et seq) has indicated that most internal audit appraisal activity is generally concerned with the appraisal of management control activities. The focus there was on the subject matter in general; the focus here is on the extent to which auditors are (i) involved in the appraisal of various aspects of existing management control systems and (ii) able to go beyond this to provide more constructive audit services.

To begin with, the internal auditor provides expertise which allows him to assess the extent to which management's arrangements for control at all levels have (a) operated efficiently, and (b) need to be developed. Accordingly, the first necessity of audit work is that a review and appraisal of management control systems in terms of existence, compliance, and adequacy should be carried out by the internal auditor. Including here, as a basic protection for management, would be how well controls provide for:

- (a) protection of resources of the enterprise from losses of all kinds.
- (b) adequate and accurate information for management decision-making, and
- (c) control of the overall phases of business operations.

Audit managers were first asked to indicate whether reviews and appraisals of existing management control systems are carried out by the audit department in their organisations. This was followed by another question in which they were requested to indicate which of the above mentioned aspects of management control are reviewed and evaluated by their audit departments (see: Q.10(i), (vi) in Appendix (B)). Their answers are presented in Tables (7.1) and (7.2) subsequently.

Based on the data in Table (7.1), all audit departments in the organisations responding are engaged in the review and appraisal of existing management control systems. The calculation at ".95 level of confidence" has resulted in a 2.77 to 2.97 confidence interval which indicates that the average population response to this question falls within the range of "extensive" on the 3-point scale used. Thus, internal auditors are *extensively* involved in the review and appraisal of existing management control systems with a .95 confidence coefficient. This evidence is consistent with the earlier findings reported in this study (see: 6.1 et seq). It is consistent with the generally accepted nature of the audit task.

A much clearer picture is revealed through the answers obtained and presented in Table (7.2) and, based on them, it appears that the degree of emphasis placed upon evaluating each aspect of control varies slightly.

Table (7.1)*

Internal Audit's Involvement in the Review and Appraisal of Existing Management Control Systems

Scale	Extent of Appraisal	NVC	Pct.	Cum.Pct.
3	YES Extensive	41	87	87
2	Moderate	6	13	100
1	Little	-	-	
0	NO	-	-	
		47	100	
Mean: 2.87 S.D.: .34 .95 C.I. 2.77 to 2.97				

* One organisation did not answer this question

Ascertaining the extent to which resources of the enterprise are properly protected and safeguarded from losses of all kinds appears to be universally carried out by all audit departments responding: this is done *extensively* by 92% of the valid cases. With .95 confidence this degree of involvement is also expected to be representative of internal auditors in general (see Item (a) in Table (7.2)).

In fact protection of the organisation's resources has always been one of the most basic activities of the internal auditor, and because of the increasing complexity and volume of the operations of the modern corporation, there is an increasing, continuing need on the part of management for such a protective audit service (see: Sec. 1.6).

Ascertaining the reliability of information developed within the organisation for management decision-making is carried out in 96% of valid cases. The calculation at ".95 level of confidence" has produced a 2.5 to 2.9 confidence interval for the average of the population response to this question - which suggests a high degree of audit involvement in evaluating the data developed within the organisation for management decision-making, though relatively less than the degree of audit's involvement with protection of resources of the enterprise (see item (b) in Table (7.2)).

A follow-up of this point during the in-depth investigation of audit reports has indicated that this kind of audit service covers a wide range of situations both in terms of the type of information being ascertained (i.e. financial and non-financial data) and the degree of significance (i.e. further analysis and use of data being ascertained).

In the accounting and financial areas ascertaining the reliability of data may take the form of a verification activity which involves the financial statements of the company, or of some divisions or subsidiaries within the organisation. In other cases, the verification activity is directed at particular items in the financial statements - as for example cash, accounts receivable, and inventories.

Although the first priority of audit work in this respect is still with the accounting/financial type of

Table (7.2)

Aspects of existing internal controls evaluated
in represented organisations

Which of the following activities are done by the internal audit department of your organisation?

- Evaluation of internal control systems from the standpoint of how well they provide for:

(a) protection of resources of the enterprise from losses of all kinds.

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	44	92	92
2	Moderate	3	6	98
1	Little	1	2	100
0	NO	-	-	
		48	100	
Mean: 2.9 S.D.: .37 .95 C.I. 2.8 to 3.0				

(b) information that is adequate and accurate to management decision-making needs.

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	36	75	75
2	Moderate	9	19	94
1	Little	1	2	96
0	NO	2	4	100
		48	100	
Mean: 2.7 S.D.: .62 .95 C.I. 2.5 to 2.9				

(c) control of the overall phases of business operations

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	28	59	59
2	Moderate	12	25	84
1	Little	5	10	94
0	NO	3	6	100
		48	100	
Mean: 2.25 S.D.: .90 .95 C.I. 2.1 to 2.6				

data, the degree of emphasis seems to be relatively shifting to a concern for non-accounting and non-financial types of data, and there is evidence which indicates that internal audit effort in this respect not only provides a protective service but also has the objective of finding a better way to do things.

The following is an excerpt taken from an audit report. It shows the extent to which ascertaining the reliability of management data can be utilised as a basis for rendering constructive audit service.

"... List of matters discussed with management to which general reference is made in our Report No.9.

1.
2. Wasted Journeys - Transport cost - 19XX, £244,000.
The last analysis showed that 15.6% of journeys by the haulier in collecting or delivering cabinets to the trade were wasted.

Our tests indicate that 93% of these wasted journeys could be avoided if sufficient and accurate information was made available.

We recommend that a standard form, possibly following the new X's system, be introduced with details of all salient facts for delivery or collection and that necessity for correct completion by the field sales staff of the parent companies be stressed."

It is interesting to note that a follow-up of this particular audit point in subsequent audit reports issued in the same organisation revealed savings that had been achieved as a result of the analysis done by the audit department of £32,000.

As we move towards item (c) in Table (7.2), we find that the relative emphasis placed on an evaluation of

internal control systems from the standpoint of how well they provide for control of the overall phases of business operations is less than that which is placed on the other two aspects of internal audit activity in the area of evaluating existing management control systems. This is evident from the comparison between the averages of the population response attached to each item in Table (7.2). However, this does not alter the fact that the appraisal of existing systems from the standpoint of how well they provide for control of the overall phases of business operations is extensively carried out by the audit departments in 94% of the organisations responding.

7.1.2 Participation in systems design and the development of future corporate plans

Involvement with systems design implies two inter-related but still fairly separate aspects of internal audit work. The first has to do with recommending actions which will enhance the soundness of the proposed systems. There is invariably another staff group responsible for the design phase and the internal auditor's role is to assist in the revision or development of systems and procedures prior to their implementation, and from the perspective of the internal control features which should be built into the new or modified systems. With such an advisory role the internal auditor's service in this respect could be expected not to be subject to too much resistance.

Based on data shown in Table (7.3), 98% of audit managers indicated that the audit departments of their

organisations are involved in the review of newly developed or revised systems and procedures prior to their adoption. Yet, a confidence interval at .95 level of confidence indicates that the average of the population response to this question is between 2.0 to 2.43 on the 3-point scale used. This evidence suggests that reviews of newly developed or revised systems or procedures prior to their adoption are having a *moderate to extensive* degree of involvement from audit departments (see Table (7.3)).

The second aspect of internal audit work in the area of systems design applies to the actual development and installation of new systems or procedures. Here the internal auditor would be more than just an advisor, he would actually share responsibility for the design process itself. Considering the established concepts of independence and objectivity, the desirability of internal auditors to be responsible for the actual development and installation of systems and procedures might not be justified and accepted (see: Sec. 2.3.3). Mints calls this the participative approach,⁽²⁾ and Allen has experimented with it successfully in the U.S. internal audit department of Levi-Strauss.⁽³⁾

In practice, however, there seem to be signs of a modified approach in this respect. Table (7.3)

2 Mints, F.E., loc. cit.

3 Allen, B.L., loc. cit.

Table (7.3)

Internal Audit's Involvement with Systems
Design and Installation

*Which of the following activities are done by the internal audit department of your organisation?

- Review and appraisal of existing management control systems

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	41	87	87
2	Moderate	6	13	100
1	Little	-	-	
0	NO	-	-	
		47	100	
Mean: 2.87 S.D.: .34 .95 C.I. 2.77 to 2.97				

- Review of newly developed or revised systems and procedures prior to their adoption.

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	17	36	36
2	Moderate	24	51	87
1	Little	5	11	98
0	NO	1	2	100
		47	100	
Mean: 2.21 S.D.: .72 .95 C.I. 2.00 to 2.42				

- Development and installation of new systems and procedures

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
3	Extensive	11	23	23
2	Moderate	10	21	44
1	Little	7	15	59
0	NO	19	41	100
		47	100	
Mean: 1.28 S.D.: 1.23 .95 C.I. .92 to 1.64				

* One organisation did not answer this question

shows that 59% of audit departments in the organisations responding are involved in the actual development and installation of new systems and procedures. With .95 confidence, the average of the population response to this question is between .95 to 1.64 on the 3-point scale used which suggests a *little to moderate* range of internal audit's involvement with the development phase of new systems and procedures (see Table (7.3)).

For the reason of comparison, data presented in Table (7.1) is included in Table (7.3). This comparison between the three aspects of internal audit's involvement with the review of management systems reveals that reviews and appraisals of existing systems are universally accepted, which is in line with the nature of the generally accepted internal audit task (see: 6.1 et seq). Some reservations exist regarding internal audit's involvement with reviews of newly developed or revised systems and procedures prior to their adoption, whereas most reservations seem to be in the area of the actual design and installation of new systems and procedures (see also Table (7.6)). Nevertheless, the same comparison generally indicates the existence of a high degree of acceptance of the internal auditor's contributions in all of these aspects of management systems.

These results may be compared with the answers received on a similar question used in Research Report No.1 of the I.I.A. (U.K.), 1976. The results published in this report are reproduced here in Table (7.4).

Generally speaking, the findings of this study (see Table (7.3)) are consistent with those shown in Table (7.4). However, bearing in mind that the latter were published in 1976, the former indicates an upward trend which is another indication of the increasing level of internal audit activity in participation in systems design.

7.1.2.1 . One clear indication of this interest is the newly existing need for internal auditors to participate in the actual development of modern computerised systems.

Additional explanations concerning the findings of the I.I.A., Research Report No.1, were introduced in the Second Annual Conference on Recent Developments in Internal Auditing, 1977.

Among these explanations reported is the following:

"In the computer area 39% (of the organisations responding) state internal audit carries out audits of systems at the development stage, 37% at the operational stage, and 42% both."(4)

Based on the investigation of audit reports, the internal auditor's role in this respect seems to be restricted to making recommendations with regard to internal control features which should be incorporated into the proposed systems. The following quotation taken from an audit report is illustrative:

4 Smallbone, M.J. (2) op. cit., pp.142-143.

Table (7.4)*

Internal Audit's Involvement with Systems

	YES	NO	No reply
	%	%	%
● Do the Internal Auditors carry out appraisal of existing systems?	88	6	6
● Do the Internal Auditors assist in the revision or development of systems prior to their implementation?	73	20	7
● Are the Internal Auditors responsible for the development and installation of new procedures?	39	55	6

* Source: The I.I.A., Research Report No.1
 "A Survey of Internal Auditing in the U.K.",
 (U.K. Chapter, I.I.A., Inc., 1976) pp.11-12.

"... Basically we have performed jointly - with EDP - all the work required under the heading of (A) in the EDP environment. In particular we have been through the I.C.Q. in depth and have completed approximately 50% of the detail installation of the (A) programme

From the internal audit point of view our discussions with EDP have been most helpful and have grounded many of the points we have outstanding into the disciplines and academics of the new reporting requirements. I think internal audit's contribution is best covered by summarising all outstanding points in summary fashion, cross referenced back to the detail I.C.Q. on the organisational controls."

7.1.2.2 There is also emerging in a number of organisations the view that internal auditors can render constructive services in a more positive sense by participating more actively in the development of forward planning systems of the organisation on an advisory basis.

The rationale here is that the internal auditor with his broad company experience can make an important contribution to the making of the decision which concerns future plans, and when he participates at this decision-making stage the internal auditor is doing so because he is in fact the most natural and uncommitted participant - a special tribute to his independence. Secondly, forward plans (whether the development of a corporate plan, or the decision to make a capital investment, etc.) should be made according to a system and the internal auditor is well placed to confirm that this system is (a) complied with, and (b) adequate. It is more constructive for the auditor to conduct this appraisal at the time the plan is drawn up rather than (say) five years later when the plan has been executed.

It could be argued that by participating at this decision-making stage the internal auditor sacrifices his objectivity which is an important factor of his independence, yet this may not necessarily be the case. And the newly existing need for the internal auditor to participate in the review of forward planning systems may be a proper risk to take if his contribution can be of value to management.

To cast light on this prospective extension in the internal audit function, audit managers were asked to indicate whether or not they are required to appraise corporate plans relating to a future which has not yet occurred. If the answer were "YES", the respondent was requested to indicate on what topics had his audit department issued reports relating to the future of his organisation during the last three years (back from 1976). If the answer were "NO", the respondent was requested to give a short description of other methods, if any, which had been developed to cover this ground (see: Q.12(a), (b) and (c) in Appendix (B)).

With reference to the main question, Table (7.5) shows that 23% of the respondents replied in the affirmative whereas 77% answered in the negative. At .95 level of confidence, the average of the population response to this question is between .11 to .35 on the two-point scale used which indicates that internal auditor's participation in the review of the forward planning systems of the organisation has actually gained

Table (7.5)

Internal Audit's Involvement with the
Appraisal of Forward Planning Systems

- Is the internal auditor required to appraise corporate plans relating to a future which has not yet occurred?

Scale	Answer	NVC	Pct.
1	YES	11	23
0	NO	37	77
		48	100
Mean: .23 S.D.: .43 .95 C.I. .11 to .35			

- If 'NO', what other methods or means, if any, have been developed to cover this ground (i.e. an independent review of future plans)?

(Please give a short description).

Categories	NVC	Pct.
1. Board of Directors or Executive Committee of the Board.	16	43
2. Planning Department	7	19
3. Management concerned	4	11
4. Other	1	3
5. No Answer	9	24

some sort of acceptance - though it is done in only a few cases.

Examples provided by those audit managers who answered "yes", on topics which relate to audits of future management phases include involvement with marketing policies, production projects, capital expenditures, budgets of individual company divisions, and computer applications.

Respondents further stated other involvement in pre-event auditing such as "instrumental in drawing up an operating manual to include executive instructions for subsidiaries, and an annual appraisal of the organisation's income/expense budget."

As shown in Table (7.5), however, it appears that the main responsibility for the review and appraisal of the forward planning systems of the organisation in 43% of cases is attached to the Board of Directors and/or an Executive Committee of the Board. Planning Departments within the organisations responding come next with 19% of valid cases, and this responsibility is stated as being left to "management" in 11% of valid cases. Under "Other" category shown in Table (7.5) comes one case in which "a working party which includes audit opinion" has responsibility for the review of future plans.

It is interesting to note that some audit managers stated that they were preparing their plans for internal audit to be involved in this area, as the following comment reveals:

"New policy under way - currently checking historic reports, will grow to check forecasts/budgets within one year."

The audit manager in another organisation pointed out that:

"All systems changes, new plans and projects, etc. are formulated and referred to internal audit for comment and approval of controls. Normally, the changes will have been always discussed and approved in principle by the management concerned before reference to internal audit. However, a fundamental major change of policies and systems in an important area will involve internal audit from initial meetings through to completion of the operation."

Although the internal audit role in conducting pre-event auditing seems to be limited in actual practice, however the basic management need for information that is accurate for its decision-making is invariably verified by the auditor, as the following comment provided by an audit manager illustrates:

"Management concerned have total responsibility for the review of their future plans. We appraise the validity of any management information used in plans and would comment on any aspects which relate to organisational controls."

Other audit managers expressed the opinion that they want to extend the scope of their audit work to include pre-event audit but they are not allowed to do so. The following comments are illustrative:

"The company does not yet agree with me to become involved in such activity."

* * * *

"Although I agree with the basic concepts of X's audit policy and philosophy, I have previously been used to a more 'positive' audit role with direct involvement with management in designing and amending policies and systems. I agree that it is difficult to say whether audit should be involved in 'helping' management make their proper decisions."

However, other research⁽⁵⁾ has reported practical evidence highlighting the development of pre-event auditing which recognises that control operates in the present and the future and there is only limited value in concentrating audit effort on past events. In this research, respondents answered a set of questions as shown in Table (7.6)

Table (7.6)*

Internal Audit's Involvement with Pre-event Auditing

In your audit work do you ever get involved in audits of:		
	YES	NO
• computer system proposals before the system goes live?	88%	12%
• contract terms before the contract is signed?	25%	75%
• capital investment proposal before expenditure is committed?	13%	87%
• corporate plans for a future which has yet to happen?	13%	87%

7.1.2.3 These results are further supported by the information deduced from responses to another set of questions in which audit managers were asked to indicate whether their audit departments render any sort of assistance in carrying out investigations which specifically relate to future management phases (see Q.24 in Appendix (B)).

5* Chambers, A.D. (3), op. cit., p.96.

The questions asked and the answers obtained are arranged here as follows:

(a) Standards development and design

The more recent Standards for the Professional Practice of Internal Auditing provide that:

"Management is responsible for setting operating standards to measure an activity's economical and efficient use of resources. Internal auditors are responsible for determining whether:

1. Operating standards have been established for measuring economy and efficiency."(6)

This statement clearly indicates that it is management that has the main responsibility for standards design and the internal audit role is basically to ensure management that there are adequate standards established and in use, and this includes probing for causes of any deviations and the appraisal of their significance.

It might, therefore, seem that the internal auditor has little concern about standards *establishment* and *design*. However, the very fact that he is made responsible for reporting on the efficiency and economy of operations is why he should seek to be of assistance in this respect. To illustrate, efficiency takes standards of action as given and focuses attention upon actual realisation and the variance therefrom. Economy, or the elimination of waste, is a matter of choosing the most economic means and deciding upon the course of action which is most economical in terms of relative costs. To be economical implies that the standard is kept to a

6 The I.I.A. (1), op.cit., p.300-2.

minimum. Accordingly, it is not the comparison of a standard with an actual which is important, as this is in fact a clerical procedure, but it is the setting and application of certain tools of analysis as means of measuring economy and efficiency that counts. And as he is the control specialist with broad experience of company operations, the internal auditor should play his role in standards design.

The specific manner in which the internal auditor's role can be performed centres upon the factual input that is provided to management as a basis for standards development. On the cost side the needed input should not only be reliable historical cost data - a traditional concern of the internal auditor - but also satisfactory estimates of future cost levels. On the revenue side there is the needed input relating to the analysis and testing of market demand which includes sales forecasts in relation to factory capacity. There is also the study and projection of possible action by important competitors - it is indeed an area which needs the internal auditor's consideration.

Of the organisations responding, 42.5% stated that their audit departments are engaged in investigations which involve appraising the soundness of the build-up of standards at the time they are formulated. With .95 confidence, however, the average of the population response is between .59 to 1.41 on the 5-point scale used - see Table (7.7) item (1). This evidence suggests that the build-

up of standards at the formulation stage is *seldom* subject to internal audit appraisal.

(b) Production planning

The basis for the decision to manufacture products could be available to the internal audit department within the organisation so that they can review its reasonableness. In making this determination, the internal auditor's concern centres upon the reliability of input data such as sales forecasts and desired inventory levels as well as the period of time planned. He must also make sure that the production plan furnishes management with such needed information as manpower, materials requirements, and machine loading sequences.

As a matter of practice, however, only 12% of the audit managers stated that their audit departments are involved in making investigations relating to the decisions to manufacture products at the planning stage. Also, as shown in Table (7.7) item (2)), with .95 confidence the average of the population response is between .03 and .43 on the 5-point scale used which suggests a very low degree of involvement by the internal auditors in this respect.

(c) The budget process

The interest of the internal auditor in the total budgetary process has a number of important dimensions. The first of these exists when he reviews the activities of the budget department. This will include the design of the basic policies and procedures, the scope of

instructions issued, and the establishment of revenue expenditure budgets for the entire organisation. This first-hand involvement has an additional benefit in that the internal auditor has an opportunity to observe directly the way the total organisation procedure is designed and administered.

Though 35% of audit managers stated that their audit departments are involved in investigating the establishment of revenue expenditure budgets for the organisation, however, the calculation "at .95 level of confidence" has resulted in a .38 to 1.08 confidence interval for the average of the population response on the 5-point scale used (see Table (7.7) item (3)).

This evidence indicates that this phase of the budgetary process is also *seldom* subject to internal audit appraisal.

(d) The development of capital expenditure decisions

The decisions relating to capital expenditures normally come about through a series of stages, which can be summarised as follows:

1. Relation with company strategy - the choice of company strategy necessarily takes into account the kinds of facilities, and their value, which would be required to effectively support the particular strategy in a satisfactory manner. There exists therefore at this stage a kind of general approval of a fairly definitive facilities programme, which then remains valid until there are developments that require a revision of the strategies to be pursued.

Table (7.7)

Examples on Internal Audit Investigations which
relate to Audits of Future Management Phases

- Does the internal audit department render any sort of assistance to carry out the following investigations:-

1. The soundness of the build-up of standards at the time they were formulated where standard costs are in use (e.g. sales forecasts in relation to factory capacity, whether expense budgets have regard to past performance and are conditioned to anticipated future conditions, etc., etc.,)?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	2	4	4
4	Mostly	3	6	10
3	Often	2	4	14
2	Sometimes	6	12.5	26.5
1	Seldom	8	16	42.5
0	Never	27	57.5	100
		48	100	
Mean: 1.0 S.D.: 1.46 .95 C.I. .59 to 1.41				

2. The decision to manufacture products with the laying down of the necessary plans?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	-	-	-
4	Mostly	1	2	2
3	Often	-	-	2
2	Sometimes	2	4	6
1	Seldom	3	6	12
0	Never	42	88	100
		48	100	
Mean: .314 S.D.: .722 .95 C.I. .03 to .43				

continued/...

Table (7.7)

3. The establishment of revenue expenditure budgets for the organisation?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	2	4	4
4	Mostly	-	-	4
3	Often	2	4	8
2	Sometimes	6	12.5	20.5
1	Seldom	7	14.5	35
0	Never	31	65	100
		48	100	
Mean: .73 S.D.: 1.25 .95 C.I. .38 to 1.08				

4. The decision to undertaken capital expenditure projects?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	1	2	2
4	Mostly	2	4	6
3	Often	1	2	8
2	Sometimes	6	12.5	20.5
1	Seldom	11	23	43.5
0	Never	27	56.5	100
		48	100	
Mean: .813 S.D.: 1.214 .95 C.I. .47 to 1.16				

continued/...

Table (7.7)

5. The control exercised over authorised capital expenditure?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	11	23	23
4	Mostly	4	8	31
3	Often	3	6	37
2	Sometimes	10	21	58
1	Seldom	1	2	60
0	Never	19	40	100
		48	100	
Mean: 2.1 S.D.: 2.03 .95 C.I. 1.53 to 2.67				

6. The verification of accounting returns recording historical data and their relation to budgets, before they are submitted to management?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	2	4	4
4	Mostly	2	4	8
3	Often	4	8	16
2	Sometimes	7	14.5	30.5
1	Seldom	3	6	36.5
0	Never	30	63.5	100
		48	100	
Mean: .98 S.D.: 1.48 .95 C.I. .56 to 1.40				

2. Developing the capital expenditures budgetary plan - during the time when the profit plans are being developed the various types of forward action proposed will normally involve replacement of, or addition to, facilities. It is then necessary for management to consider all of these needs for facilities as a total problem. This must also be done in order to be sure that aggregate capital expenditures do not exceed the financial capabilities of the organisation. Also this is vital so that the proper priorities can be evaluated as between the competing needs of individual organisational units. Thus, the development and finalization of the profit plans involves at the same time the development of the capital budget. This capital budget, as it is usually termed, consists of the total planned capital asset programmes. These programmes cover estimates of the total cost of the capital projects together with the funds required for the individual years during which the individual programmes are being completed. However, none of these preceding actions constitutes authorisation for actual capital expenditures.
3. The delegation of project approval authority - normally, actual capital expenditures will be approved in the form of facilities or capital expenditure projects. Here, determinations must

first be made as to what approval and concurrences will be required for projects at various value levels. The higher the level of responsibility of the individual manager the greater this authority. It is therefore necessary in the subsequent control over the delegation of project approval authority to be sure that projects are not deliberately broken up to keep them within the authorized limits.

4. Later control and evaluation - the approved projects should be subject to continuing control for progress and conformity with authorised cost levels. Post audits should also be made after the completion of the projects.

Bearing this in mind, the internal auditor is vitally concerned with all of these phases in the development of capital expenditure decisions. And his major competence in the field of control - including his special competence in basic financial controls - gives him a credential for entry into these areas. It must be recognised, however, that his contribution here will be constructive in a more positive sense when the internal auditor gets involved in the first two stages referred to above, and protective when he limits the scope of his appraisal to the latter control and evaluation only.

Of the organisations responding, 43.5% indicated that their audit departments are engaged to various extents in making investigations which relate to the development of capital expenditure decisions. But with

.95 confidence such investigations are *seldom* carried out by audit departments in actual practice (see Table (7.7) item (4)).

On the other hand, it appears from the answers received that 60% of audit departments are involved in the investigation of control over authorised capital expenditures. The calculation at ".95 level of confidence" has indicated that the average of the population response is between 1.53 and 2.67 on the 5-point scale used which suggests that such audit activity has a *sometimes* to *often* involvement - a degree of involvement which is not shared with any other item in this set of questions (see Table (7.7) item (5)).

(e) Analysis of financial reports

One purpose of financial reports is to provide historical information for the record and for latter reference. But the more important purpose is to be a constructive force for current action which will make possible a better future. In part the latter is achieved by looking at the past and interpreting its implications. In part also this is accomplished by developing forward estimates and projections. The benefit here is that by recognising the indicated future directions, management can know better what actions should be taken now to improve the future results.

While the finance function is very much concerned with the means by which such analysis can be better carried out, the standing of the internal auditor in the accounting and financial field provides a special opportunity for

ascertaining the reliability of accounting and financial data developed within the organisation before it is submitted to management for decision-making needs.

Only 36.5% of the organisations responding indicated that their audit departments carried out such verification. Here it is an area where presumably the internal auditor has his most obvious competence yet, with .95 confidence, it is *seldom* subject to internal audit (see Table (7.7) item (6)).

7.2 Secondly: The nature of audit points made to management

Internal audit points made to management have special importance in the reporting phase of the internal auditing process for they are expected to present a picture of conditions on which management decisions may be based.

And from the standpoint of this study, audit points provide a natural opportunity to integrate the discussion of the total internal audit activity and can be used as a basis for an overall analysis of the nature of the internal audit function in terms of various protective and constructive audit services.

The approach of the internal auditor, as he is the control specialist, is to cover the protective needs in a manner which avoids emphasis in that direction, and instead to stress the constructive potentials and the broader approach - see: (7)(e) in Appendix (F). This broader approach, however, does not deny the fact that the internal auditor has certain basic responsibilities in connection with protective audit services. What needs

to be recognised is that protective audit services could very much be the basis for determining a better way to do things in addition to maintaining an adequate level of protective safeguards. Accordingly, for a meaningful evaluation of the nature of internal audit effort both types of service should be considered. In doing so, it is useful to know first the main purpose of internal audit points made to management as perceived by internal auditors themselves.

7.2.1 Internal auditors' reporting emphasis

In the current stage of internal audit development there is a general recognition that internal audit work will be far more constructive when it goes further than merely pointing out observed weaknesses in the audited areas and includes recommended solutions for operating improvements. An extension of such a nature is likely to be of value to the organisation, and the internal auditor is likely to find a more cooperative auditee when he helps local management to do a more effective job., thus making it easier for him to do good audits and increasing internal audit job satisfaction.

Based on information shown in Table (7.8), in making their audit points it appears that internal auditors are doing more than merely identifying the problems associated with the audited areas. 81% of audit managers expressed the opinion that audit points should not be limited to problem identification only, and with .95 confidence this opinion is expected to be

Table (7.8)

Audit Managers' Reporting Emphasis

* The main purpose of internal audit points made to management is:

1. merely to identify the problems within the audited areas, i.e. pointing out weaknesses.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	6	12.5	12.5
2	Uncertain	3	6.5	19.0
1	Disagree	39	81.0	100.0
		48	100	
Mean: 1.31 S.D.: .689 .95 C.I. .62 to 1.99				

2. identifying the problems and making recommended solutions

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	47	98	98
2	Uncertain	-	-	98
1	Disagree	1	2	100
		48	100	
Mean: 2.96 S.D.: .289 .95 C.I. 2.86 to 3.0				

3. emphasising organisational weaknesses and making recommendations for organisational improvements with less emphasis on procedural weakness and procedural recommendations.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	20	42	42
2	Uncertain	14	29	71
1	Disagree	14	29	100
		48	100	
Mean: 2.13 S.D.: .84 .95 C.I. 1.88 to 2.37				

* See Q.15 in Appendix (B)

representative of the general attitude between internal auditors.

This positive attitude is also evident from the manner in which audit managers responded to the second statement in Table (7.8). 98% of audit managers agreed that the main purpose of audit points is to both identify problems and suggest how to resolve them. This opinion is also representative of the internal auditors' general attitude at .95 level of confidence.

Nevertheless, unanimity did not exist as to the third statement shown in Table (7.8). Only 42% of audit managers believe that the identification of organisational weaknesses and recommending their improvements should have precedence in making audit points to management, whereas the remaining 58% is equally shared between audit managers who have expressed uncertainty and those who are in disagreement with the third statement in Table (7.8). The calculation at ".95 level of significance" indicates this uncertainty regarding the third statement in Table (7.8). It must be recognised, however, that most audit managers who are in disagreement with the third statement in Table (7.8) stated that both procedural and organisational weaknesses, in their opinion, are equally important and their identification coupled with recommended actions for their improvements should be emphasised by audit.

It is appropriate now to turn to what actually happens in practice - that this the analysis of audit

points based on the investigation of internal audit reports.

7.2.2 Analysis of audit effort in terms of various protective and constructive audit services

It was hypothesised that "Internal auditors are generally successful in making audit recommendations which:

- (i) emphasise the basic protective aspects of the operations reviewed as well as the improvement of these operations.
- (ii) help auditees to recognise their own problems and inefficiencies.

To test this hypothesis it will be useful first to identify some general guidelines to distinguish between audit points which are protective in nature and those which have constructive features.

It is already known that all functional areas within a company need basic protective safeguards that must be provided for. That is to say, all basic and underlying systems of control must be maintained at a satisfactory level of efficiency, the organisations' policies and procedures must be complied with, and the assets of the organisation must be properly protected.

While management is generally responsible for establishing the means for complying with protective measures, it is the responsibility of the internal auditor to determine whether those means are adequate and effective, and whether the organisation is generally in compliance.

Accordingly, an audit point tends to have that kind of protective character when it highlights:

1. A breakdown in approved internal controls, and/or
2. Non-compliance with established protective measures.

Under the first category come audit points which are limited to identifying the problems within the audited areas (i.e. pointing out weaknesses). Typical situations of this will include audit points which indicate lack of control over a particular area, inadequate organisational arrangements, and procedures needing revision.

The second category refers to audit points which highlight unfavourable developments or inefficient practice as a result of not giving adequate attention to the soundness of established protective measures and safeguards. Typical situation of this will include irregularities due to all kinds of fraud and dishonesty, and other financial losses when resources of the enterprise are subjected to losses through inadequate control and accountability.

A second aspect of the audit service can arise where extra benefits can be obtained through various types of improvement. These improvements can generally be made possible as a result of better design of approved systems of control, different policies and procedures, adjustment of protective standards, and/or through recommendations which can yield better results - that is greater achievement of objectives.

In conformity with this, an audit point is considered to be of a constructive nature when it represents:

1. Strengthening in internal controls, and/or
2. Recommending operating improvements.

Under the first category come audit points which exceed the range of merely pointing out weaknesses in established internal controls to include suggestions calling for changes in underlying systems, policies, and procedures. Typical situations of this will include identifying the absence of an internal control over a particular functional area associated with the recommended corrective action needed, recommendations calling for organisational and procedural changes, and identifying policies needing revision.

The second category refers to audit points which represent identification of a specific way in which higher levels of operational efficiency can be made possible. Typical situations of this will include the development of an internal audit conclusion that operating costs can be reduced and/or profitability can be increased if certain recommended actions are taken in a specific area of operations.

It is believed that the above mentioned guidelines can be used as a suitable basis for investigating the nature of internal audit points made to management in terms of various protective and constructive audit services.

The procedures taken to carry out this investigation were as follows:

1. An in-depth analysis in all 363 final, formal audit reports on the organisation's activities produced by audit departments participating in this phase of the study was carried out. In this analysis audit points made to management were categorised according to the general guidelines referred to above.
2. As a first step in conducting the statistical test, a ratio analysis of audit points under the various categories is made.
3. To determine whether any difference in the nature of audit points in the sample under investigation (i.e. the 363 audit reports) is due to chance or is statistically significant, audit points made to management under both protective and constructive categories were calculated and a test of the significance of the difference between the means of the two categories at .95 level of significance was carried out.

Results of this investigation are shown in Table (7.9) and based on them several conclusions seem appropriate.

It appears that the type of audit emphasis has shifted to the more constructive type of approach. In support of this, Table (7.9) shows that 60.7% of audit points made to management in the organisations responding to this phase of the study have that kind of constructive character. As against this 39.3% of audit points relate to the protective type of audit services.

This is further supported by the comparison between the ratios of audit points subsumed under the two main categories in Table (7.9). On the one hand, 36.7% of audit points made relate to suggestions and recommendations calling for changes in existing internal controls or better implementation, whereas 29.6% of audit points relate to merely pointing out observed weaknesses in approved internal controls.

On the other hand, recommendations for operating improvements account for 24% of audit points made as against a ratio of 9.7% relating to non-compliance with established protective measures.

It is interesting, however, to go further and examine individual ratios in Table (7.9).

7.2.2.1 Observations on weaknesses v recommendations for improvements in internal controls

To some extent the objective of the internal auditor is essentially to protect the existing situation. From this angle, the internal auditor's role would mainly be directed to reassure management that their arrangements for control have been adequate, economic, and operated efficiently. This will include, first, identifying and drawing the attention of management to weaknesses in all measures which are economically unsound, and second, making suggestions for the prevention of future shortcomings and/or improved performance.

The internal auditor's role here will be protective to the extent that audit points made to management are

Table (7.9)

Analysis of Internal Audit Points made to Management
in terms of various Protective and Constructive services

Protective services (1)	Pct.	Adj.Pct.	Constructive services (2)	Pct.	Adj.Pct.	
<ul style="list-style-type: none"> ● <u>Observations on weaknesses in internal controls:</u> <ul style="list-style-type: none"> - Identifying lack of control over particular area - Procedural weaknesses - Organisational weaknesses - Policies needing revision 	2.0	5.0	<ul style="list-style-type: none"> ● <u>Recommendations for improvements in internal controls:</u> <ul style="list-style-type: none"> - Recommending new control over particular area - Procedural changes - Organisational changes - Policies modifications 	2.4	4.0	
	19.8	50.0		24.1	39.0	
	7.8	20.0		10.2	17.0	
	-	-		-	-	
	29.6			36.7		
<ul style="list-style-type: none"> ● <u>Non-compliance with established protective measures</u> <ul style="list-style-type: none"> - Irregularities - Other financial losses 	4.3	11.0	<ul style="list-style-type: none"> ● <u>Recommendations for operational improvements</u> <ul style="list-style-type: none"> - Reduction in operating costs - Increment in operating profitability 	15.2	25.0	
	5.4	14.0			8.8	15.0
	9.7				24.0	
	39.3	100			60.7	100
Mean(1): 2.96	S.D.(1): 2.61		$\alpha = .05$ (i.e. $z = 1.96$)			
Mean(2): 3.86	S.D.(2): 2.69		$Z = -4.60$			

confined to merely pointing out observed weaknesses in internal controls, and constructive in more positive sense when it is indicated that changes in the established measures are what are really needed.

The original ratios attached to individual items shown in Table (7.9) indicate that internal auditors are generally successful in making audit points which relate to the constructive approach. And it appears that when adequate controls are lacking, the internal auditor not only reports their absence (2%) but also recommends that new controls over the particular functional area should be provided for associated with his suggestions as to how the corrective actions might be taken (2.4%).

The same pattern can be recognised in reporting audit findings which relate to both procedural and organisational aspects of control.

Audit points which are confined to the identification of *procedural* weaknesses represent 19.8% of the total audit points made whereas 24.1% of audit points go further than pointing out procedural weaknesses to include suggestions calling for procedural changes.

In line with this, 7.8% of audit points are made in connection with observed *organisational* weaknesses, and 10.2% of audit points included recommended actions to overcome these observed organisational weaknesses.

It seems, however, that internal auditors are placing more emphasis on procedural aspects of control with less emphasis on organisational weaknesses

and making recommendations for organisational improvements. This is evident from the comparison between the adjusted percentages which illustrate the relative emphasis of audit work with respect to these two aspects of internal control. Table (7.9) shows that substantial consideration is given to recommendations for procedural weaknesses (50%) and procedural changes (39%), with less emphasis on organisational weaknesses (20%) and organisational improvements (17%). On the other hand, it appears also that it is easier for the internal auditor to ascertain compliance with established procedures and go on to recommend changes in procedures. But the internal auditor has some sort of resistance in justifying recommendations calling for changes in policies though it has been suggested that assurance should be given that "an organisation's *policies* (italics ours) are fulfilled, not merely that procedures function satisfactorily irrespective of whether they are the appropriate procedures."⁽⁷⁾

In fact the researcher has not found an audit point which can be classified directly under related sub-headings shown in Table (7.9), and it seems that internal audit role with respect to policies is basically confined to ascertaining the extent to which company policies are complied with and perhaps this may lead to their modification.

7 Chambers, A.D. (1), op. cit., p.40.

Despite this, based on the questionnaire responses, most audit managers have indicated that the scope of their audit involves policies appraisal (see: 4.3 et seq). Also most executive managers acknowledged that, and indicated that they were generally satisfied with the internal auditor's recommendations calling for changes in the policies by which their responsibilities are governed (see: 4.3 et seq).

The following quotations taken from audit reports are illustrative of audit points of both protective and constructive types in the general area of internal controls.

1. Reporting the absence of an internal control and recommending its establishment:

"Rebanking of unclaimed wages.

Four wage packets held in the safe, had been unclaimed for over three months.

We suggest that a system for rebanking promptly be introduced."

"Lack of Quality Control checks on incoming packaging and raw materials

Quality control are not checking packaging and raw materials entering the ... store

We recommend that necessary quality control checks are made."

2. Non-compliance with established procedures:

"A review of the stock records revealed that on several occasions (28% of those examined) orders were placed either for a greater quantity than the standard specified on the card, or before the minimum stock level had been reached.

We recommend that standard procedures should be observed."

3. Observed weaknesses in procedures:

"At the time of our audit, the company was holding finished goods stocks much in excess of the level of ten weeks which is the target level of company policy.

This high stock level is said to be caused by a reduction in demand (due to the depressed state of the economy), coupled with inflexibility in the ... production system to cope with late changes to the production indent.

Although there is theoretically an ability to change the plan up to one production period ahead, this is often not achieved in practice.

In our opinion, the level of overstocking shows weaknesses in the existing systems, both in production planning and in the Company's sales forecasting.

We recommend that the Company investigate methods of improving the flexibility and accuracy of these two systems."

4. Recommending procedural changes.

"In our discussion with ... Management it was agreed to change the stock-taking procedures. The new system would be that all stock will be counted twice yearly. In addition, the stock-taking records will be sufficiently detailed and controlled to enable them to be accountable documents."

5. Recommendations for organisational improvements.

"The organisational structure of ... has been studied. Some improvements are needed to help in effecting operational disciplines. This can be done by dotted line functional responsibility to the Manufacturing Directors to enable them to participate in solving the problems."

* * * *

"The reporting structure of the Company is very informal for a company of this size. Thus responsibilities are not, in all cases, clearly defined and senior managers become involved in many minor problems which they need not. For instance, the Accountant does a considerable amount of detailed work, instead of developing the ideas which his position and ability give him.

This problem is further accentuated by the fact that few policies and procedures are formalised in writing.

Recommendations

- (1) To clarify responsibilities, a formal organisation chart should be produced as soon as possible. Individual responsibilities can then be discussed and agreed upon. Perhaps, in particular, it is necessary for the Accountant to have an assistant to give him time to develop his ideas.
- (2) The Company's policies and procedures should gradually be formalised into a policies manual."

7.2.2.2 Non-compliance with established protective measures v recommending operating improvements

A related type of protective service exists when the internal auditor points out poor or inefficient practice on the part of the people doing the job. Such poor practice can range from relatively low types of inefficiency (e.g. an inordinate number of human errors) to the higher level types where individual assets are subjected to intentional losses (e.g. defalcations) and/or losses occur through inadequate control and accountability. While the audit work in this area has a generally protective character and while in particular situations it may take on the policeman role, yet, this does not alter the fact that the internal auditor has certain basic responsibilities in this area.

Table (7.9) shows that 4.3% of audit points are made in connection with irregularities due to fraud and dishonesty. In comparison with other protective aspects shown in Table (7.9), this is a relatively high ratio (11%). Although the detection of irregularities of all

kinds is not currently a primary audit objective, unquestionably, the discovery of individual irregularities attracts management attention and at once raises the questions of why they occurred. In addition the amount of the defalcation is determinable within reasonable limits, so that the impact of the loss upon management thinking is all the more dramatic. This is true even if the loss is recoverable under existing insurance coverage. Revealing irregularities of all kinds is therefore eagerly sought after by some internal auditors.

However, the emphasis on revealing this type of audit activity tends to antagonise the company personnel and is evidently the reason why many auditees view internal auditors as "policemen".

Table (7.9) also shows that 5.4% of audit points made relate to non-fraudulent financial losses due to inadequate control and accountability over the resources of the organisation such as ineffective collection procedures imprudent purchases, excessive stocks, faulty records, poor fire safeguards, failure to protect from weather, faulty insurance coverage and the like.

The common feature of audit points associated with all these non-compliance activities is that a definitive loss is likely to point up certain deficiencies in the established protective measures, which suggest the need for corrective actions and recommendations on operating improvements.

The improvements expected may depend upon the change of various procedures, methods, or organisational

arrangements. In other cases the basis for the improvements will be different materials, change in equipment, or modified working conditions. The end result of such suggested improvements by the internal auditor is that operating costs can be reduced in a particular operational area. A related type of constructive audit service in this respect exists when the recommended actions indicating the possibility of improvements comes, not from the reduction of operating costs, but from the increased level of value that is received (i.e. better value for current costs); for instance, by getting a higher quality of service for the same money paid or with different equipment, a particular operation may in some way be made more productive.

As shown in Table (7.9), 15.2% of audit points made tend to have that kind of constructive character, and it seems that the interest of the internal auditor in making audit points which suggest operating improvements through the reduction of costs in the operations involved is relatively high (25%).

Another type of audit finding of a constructive nature is the situation where operating profits can be increased either by eliminating deficiencies in reporting of revenue and/or when it is indicated that new sources of revenue can be discovered.

The first of these occurs where control over various types of revenue is inadequate, with the result that all

of the revenue is not being reported. Typical situations of this kind are cash sales, service fees, items erroneously omitted from billings, unauthorised price reductions, and the like.

Illustrative situations where audit points suggest new sources of revenue are the determination that waste products could be used for other purposes, or sold, or that better realisation values can be obtained by better preparation of the waste or scrap, or sometimes by recommending a wiser selection of buyers.

Table (7.9) shows that 8.8% of audit points relate to these aspects of recommending operating improvements. It appears, however, that internal auditors are placing more emphasis on their suggestions which may lead to cost savings (25%) than those which may lead to the discovery of new sources of revenue (15%).

The following quotations taken from audit reports examined are illustrative examples of audit recommendations calling for operating improvements:

1. Recommendation for improved control over outstanding debtors (£40,000).

"..., the majority of customers still fail to settle their accounts within the official terms of 30 days and we have again found lapses in laid-down procedures for credit control ...

We recommend that the Company gives closer attention to the control of export debtors and examine the case for use of ECGD insurance. Current export debtors of £19,189 represent over 6 months' sales, and significant bad debt write-offs have been experienced in the past."

A follow-up of this audit point in subsequent audit reports has indicated that:

"Matters raised in our previous report, of February 19XX, have been satisfactorily settled. The company has reversed the trend which has existed over the previous 3 years of a deterioration in the length of credit and there has been stricter enforcement of credit control procedures."

* * * *

"From our review, we formed the opinion that, the department had provided adequate arrangements for internal control over its receiving functions with the following exception:

No comparisons were being made between chemicals received and billed. Our own comparisons showed that containers were not being completely emptied. As a result we found variances of over 9%. After we discussed the matter with operating management, systems were improved and negotiations with the supplier resulted in recoveries of about £7,000."

* * * *

Some audit departments follow the practice of producing activities reports or reports of accomplishment. Among other things, these audit reports include a list of savings or potential savings which may be expected as a result of the work of the audit department during a certain period of time, usually one year. The following is a quotation taken from an audit report of that kind:

"a) Recurring:

	Area of saving	Amount per annum
X's Company, Report No.25	Discrepancy between raw materials purchased and paid for and those received	£80,000
Engineering Division Report No.1	Suggestion for insurance cover on new equipment.	potential loss £700,000
X's Company Report No.3	Identification of amount owing by third party manufacturers	£8,000
...

"b) Once for All

	Area of saving	Amount per annum
Property Dept. Report No. 1	Identified rents and service charges not invoiced	£32,000
X's Company Report No.7	Least cost formulation done by computer	£50,000
X's Company Report No.9	Recommendation to monitor income from investments (£14mn. p.a.)	Not quantifiable"

* * * *

From a statistical point of view, it was assumed that there is no significant difference between the number of audit points made in the audit reports investigated. Table (7.9) shows that the computed Z value (i.e. the measure of the difference in terms of standard errors) is greater than 1.95 (i.e. the tabular value of z at .05), therefore the null hypothesis is rejected and accordingly there is a significant difference between an average of 2.96 protective audit points per each audit report and an average of 3.86 constructive audit points per each audit report.

It is believed that this difference is large enough to the extent which allows us to say that *internal auditors are generally successful in making audit points which emphasise the basic protective aspects of the operations reviewed as well as the improvement of these operations - see :Sec. 2.6, Research hypothesis No. 3.2.*

Up to this point, internal audit managers' reporting emphasis is discussed in line with what actually happens

in practice. To complete the picture, it is important to know the attitude of other management (i.e. auditees) towards the internal auditor's approach in making his audit points.

7.2.3 Management reaction towards audit points made

Executive managers were requested to indicate their opinions regarding three statements which are negatively worded so that the answer "disagree" indicates a favourable, positive attitude.

The first statement says, "Auditors are generally unsuccessful in making audit points which help auditees to recognise their own problems and inefficiencies." Table (7.10) shows that 90.5% of the respondents disagree as to the implication of this statement, whereas 9.5% were uncertain. This evidence suggests a well established relationship between auditors and auditees in the organisations responding. With .95 confidence this positive attitude is expected to be representative of the general view of executive managers (.95 C.I. = 2.77 to 3.0 see Table (7.10)).

The second statement says, "Auditors are generally unsuccessful in making audit points which relate directly to the original objectives of the audit." In line with the same positive attitude, 85% of executive managers expressed disagreement with this statement, and 14% were uncertain. At .95 confidence, the average of the population response to this statement is between 2.7 and 3 on the three-point scale used which suggests a high degree

Table (7.10)

Executive Managers' opinion concerning the internal auditor's approach in reporting audit results

* Please indicate your opinion concerning the following statements:

1. Auditors are generally unsuccessful in making audit points which help auditees to recognise their own problems and inefficiencies.

Scale	Answer	NVC	Pct.	Cum.Pct.
1	Agree	-	-	-
2	Uncertain	2	9.5	9.5
3	Disagree	19	90.5	100
		21	100	
Mean: 2.9. S.D.: .30 .95 C.I. 2.77 to 3.0				

2. Auditors are generally unsuccessful in making audit points which related directly to the original objectives of the audit

Scale	Answer	NVC	Pct.	Cum.Pct.
1	Agree	-	-	-
2	Uncertain	3	14	14
3	Disagree	18	86	100
		21	100	
Mean: 2.85 S.D.: .36 .95 C.I. 2.70 to 3.0				

3. The bulk of audit reports related to weaknesses observed by the auditor (i.e. criticisms) with less emphasis on the strengths observed in management's systems (i.e. praise), with a consequence that auditees consider the auditor to be unfair and unwelcome.

Scale	Answer	NVC	Pct.	Cum.Pct.
1	Agree	7	33	33
2	Uncertain	2	9.5	42.5
3	Disagree	12	57.5	100
		21	100	
Mean: 2.24 S.D.: .944 .95 C.I. 1.81 to 2.67				

* See Q.6 (i), (iv) and (v) in Appendix (C).

of disagreement with this statement. Thus, as perceived by executive managers, auditors are generally successful in making audit points which relate directly to the original objectives of the audit.

The third statement says, "The bulk of audit reports relate to weaknesses observed by the auditor (i.e. criticisms) with less emphasis on the strengths observed in management systems (i.e. praise), with a consequence that auditees consider the auditor to be unfair and unwelcome." As shown in Table (7.10), responses to this statement reflect a slightly different attitude. One third of the respondents agreed upon the implication of this statement, 9.5% were uncertain, and 57.5% disagreed. Also the calculation at ".95 level of confidence" has resulted in a 1.8 to 2.67 confidence interval for the average of the population response on the three-point scale used which relatively indicates less disagreement and hence less favourable attitude. However, these results do suggest that the emphasis on pointing out observed weaknesses in the audited area and the resulting criticisms are no longer permitted to dominate the internal auditor approach. This is further supported by the comments provided by executive managers in connection with the third statement in Table (7.10).

Examples may be cited as follows:

"Purpose of audit report is to highlight deficiencies not to praise systems or people involved."

* * * *

"Audit criticisms on systems should show:

- a. What is wrong,
- b. Why it is wrong,
- c. What to do to put it right

No point in reporting matters that do not require any action or decision."

* * * *

"It is objective criticism which is of great value to me. I would like to see more internal auditors so that we could get a more informal but regular service."

* * * *

However, other executive managers seem to be in favour of reporting satisfactory conditions as well as observed weaknesses, as the following comment reveals.

"I see that the objectives of the audit should be stated clearly and that within these objectives the auditors should positively state that the performance is satisfactory or that specific weaknesses exist, and they should not hint that other weaknesses might exist if this is not substantiated."

* * * *

A follow-up of this particular aspect of the reporting phase during the investigation of audit reports and other audit material (see: secondly Q.5 and Q.6 - Appendix (D)) has disclosed that the practice of reporting favourable conditions differs from one organisation to another. In some cases they are reported as the following quotation taken from an audit report indicates.

"From the control point of view, X is a very well run company by our standards, particularly as far as the branch offices are concerned. It is also felt appropriate to comment on the constructive reception to the recommendations in our report. Many had been implemented or studied before the audit was completed."

In other cases, drawing management's attention to deficiencies in the audited areas was emphasised in the

audit report, often associated with a suggested remedy; and in the follow-up report the corrective actions taken were acknowledged. The following quotation taken from an audit memorandum is illustrative:

"The general impression gained from recent meetings and discussions is that more concern and attention is now being given to audit recommendations by senior managers who are spreading this attitude down through their companies, although there is clearly a long way to go yet."

It is also recognised that other management reaction varied as to the audit points made in individual audit reports. Sometimes the audit report is appreciated, some other times auditees express their dissatisfaction. What needs to be recognised, however, is that in either case auditees' reactions are reported. The following quotation taken from audit correspondence is illustrative:

Memorandum from Administrative Manager to S.V.

President on audit report dated 29.8.75.

"I have now had the opportunity of reading ...'s report as of the aforementioned date on London Branch. It is seldom that I have read a report prepared with such clarity and I should be pleased to receive your confirmation that you concur in the opinion that there is nothing that we as management need to do arising out of such Internal Audit Report. I should be grateful if you would convey our appreciation to ... for the excellent work which has obviously been done."

* * * *

Audit Reply:

From the Chief Accountant to the Chief Internal Auditor,

"Attached is my reply to the audit report produced by your people, for the Overseas Dept. The length of the report and items reported has necessitated the overseas Manager and myself spending many hours investigating each point. At the end of this investigation neither of us feels that the time

"spent by us has been of benefit. From our replies to the points raised in the report, you will see that there have been instances of inaccurate reporting, duplication, trivial reporting, unnecessary remarks and recommendations which have not been fully thought through."

7.3 Other internal auditing services

In the foregoing analysis, internal audit activities have been discussed in terms of various protective and constructive services.

There is, however, a group of activities that do not directly have the specific character of either of these two. These are as follows:

1. Effective communication of audit results.
2. Training of other company personnel.
3. Services in connection with the external auditing.

7.3.1 Effective communication of audit results

The consideration of the reporting phase brings to a head some significant issues which have great impact on the internal audit work.

The study of these issues provides an important means by which the nature of internal audit services can be better understood.

(a) Reporting Characteristics

Characteristics pertaining to audit reports fall generally into two categories, those pertaining to substance and those pertaining to form. The first will be dealt with here, the second is the subject matter of a latter point in this discussion. From a substance standpoint the matters with which the internal auditor

should be concerned would include the following:

(i) Addressee

One of the most important issues in discussing the reporting phase is to whom the audit report should be submitted.

Apparently, the answer appears very simple - to management. But management exists at all levels, including here the management to which the head of the audit department reports, the management of the organisational unit being reviewed, and the management at the higher levels to which the unit management is made responsible.

Looking at the issue from the standpoint of the organisational level to which the internal auditor is responsible, the question in more specific terms comes down to what support is given to the internal auditor in the organisation. That is to say it is futile to expect good results from the audit function if management is not solidly behind it. Hence, the audit results must receive adequate attention. This can seldom be achieved without acceptance for audit at a high level. The internal audit report should be directly submitted to a management official whose organisational position is sufficient to ensure proper consideration and utilisation of the report. As shown in Table (7.11), all audit managers responding agree upon this without any reservation. This opinion is also representative of the internal auditors' general attitude at .95 level of confidence.

As reported earlier in this study, there has been major upward progress in the organisational level to which

Table (7.11)

Attitude of Audit Managers Toward Internal
Audit Reporting Characteristics

* Please indicate your opinion concerning the following proposed general internal audit reporting standards:

1. The internal audit report should be directly submitted to a management official whose organisational position is sufficient to ensure proper consideration and utilisation of the report.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	48	100	100
2	Uncertain	-	-	100
1	Disagree	-	-	100
		48	100	
Mean: 3 S.D.: 0 .95 C.I. 3				

2. An expression of the specific audit objectives and scope should be contained in the audit report.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	38	79	79
2	Uncertain	4	8.5	87.5
1	Disagree	6	12.5	100
		48	100	
Mean: 2.67 S.D.: .694 .95 C.I. 2.47 to 2.87				

* See Q.23 in Appendix (B).

continued/...

Table (7.11)

Attitude of Audit Managers Toward Internal
Audit Reporting Characteristics

3. The internal audit report should contain a summary of the audit findings and an expression of the auditor's overall opinion concerning the audit area under review.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	46	96	96
2	Uncertain	2	4	100
1	Disagree	-	-	100
		48	100	
Mean: 2.95 S.D.: .20 .95 C.I. 2.9 to 3.0				

4. Recommendations for corrective actions, with recommended officials to carry out the action, should be included when considered necessary by the internal auditor.

Scale	Answer	NVC	Pct.	Cum.Pct.
3	Agree	38	79	79
2	Uncertain	5	10.5	89.5
1	Disagree	5	10.5	100
		48	100	
Mean: 2.69 S.D. .66 .95 C.I. 2.50 to 2.88				

the internal auditor reports - see Sec. 4.6.1.

Of major significance also is the increasing tendency to establish some sort of a partial reporting responsibility of the audit department to the Board of Directors.

Based on the information provided by audit managers (see Q.16(b) in Appendix (B)), in addition to the examination of distribution sheets attached to audit reports investigated (see Q.2(c)(ii) in Appendix (D)), this practice of having dual reporting relationships is based on one for normal ongoing audit activities and a second on a periodic basis with additional rights of access. Thus the auditor might report on a day-to-day basis to a Controller or to a Finance Director and sometimes to the Managing Director. At the same time a reporting relationship to the Board of Directors might be established, usually to the Audit Committee of the Board if there is one. In other cases, the second reporting relationship might be established with the Managing Director/the Chief Executive. The arrangement here might be for an annual, semi-annual, or quarterly report to these top officials, and often with the added stipulation that the head of audit department would have interim access to them as required.

Based on the investigation of the organisational charts of the organisations visited (see Q.2 a, b, and c in Appendix (D)), the first reporting relationship would be categorised as a solid-line of responsibility and the second relationship as a dotted line type of responsibility.

In effect such dual reporting relationship enhances the organisational status of the internal auditor. It also discloses to others in the organisation the degree of commitment the top management has to the nature and scope of the internal auditing role.

Looking at the issue in hand from the standpoint of other management, the question comes down to what the internal auditor's respective responsibilities are to the auditee versus the auditee's superior. On the one hand, higher management levels have very practical type of control needs. They want to be always apprised that the organisation is generally in compliance; also they want to know of major operational problems and of significant possibilities of carrying out the operations more efficiently. This is in part a need for protection and in part a desire to be helpful. As one of the important means for achieving this control these higher levels look to the internal auditor.

The internal auditor wishes to provide these higher levels with the services they seek. After all, it is these top level managers who pass final judgement upon the worth of the services of the auditor, and who influence and ultimately determine his compensation, organisational status, and overall progress in the organisation.

On the other hand, the local managers want the audit service, but they want it on a basis that in no way discredits them with upper level managers. The internal auditor wants to help his auditee to do a more effective

job, but to do this he must enjoy a full co-operation and partnership relationship. The internal auditor is, therefore, strongly motivated to deal with local management in the way the auditee wants in order to best achieve what really matters - a more efficient performance.

There are thus two types of conflicting pulls upon the internal auditor, and it appears that the further he goes in one direction the greater is the problem in the other direction. How can and how should this dual responsibility be resolved?

Most internal auditors, the literature would suggest (see Chapter 2) have resolved the problem more in the direction of servicing higher management levels, but there are some signs of modifications which appear to be promising in this respect.

The starting point to resolve this dilemma is that both management groups should be provided with a more comprehensive understanding of the needs of each other, and also of the desire of the internal audit group to serve both types of needs.

This of course must be tied closely to both the organisational levels to which audit reports are sent, and also to the opinion that top management holds of the audit group as may be shown in the management policy statement concerned with the audit function within the organisation.

Table (7.12) shows that a majority of organisations (75%) have issued a policy statement covering the authority, responsibilities, and scope of their audit

departments, whereas 25% of the organisations stated that they do not have a policy statement concerning their audit departments.

Regarding the first larger group, it seems reasonable to say that these organisations are aware of the way in which management gives its support to the authority and responsibilities of the audit function; and in turn, internal audit departments have had demonstrated acceptance in these organisations.

With respect to the second group, it is difficult to grasp how internal audit departments in these organisations can function effectively within a broader scope without such an important document.

Table (7.12)

Management policy statements concerning the audit function in the organisations responding

Is there a management policy statement covering the authority, responsibilities, and scope of the internal audit department within your organisation?		
Answer	NVC	Pct.
YES	36	75
NO	12	25
	<hr/> 48	<hr/> 100

See Q.5 in Appendix (B)

A second way in which the problem can be minimised is through raising the level of what shall be considered sufficiently significant or material to warrant report

coverage. In this way many of the more minor matters that should be, and can be finalised at the local level, might be eliminated without the irritations that come from involving higher level managers.

Illustrative of this point is the following comment provided by an audit manager in a large organisation.

"The general principle is to keep dialogue at site level unless matters arise which require discussion or action at a higher level.

If dishonesty is apparent, then the site is by-passed and the matter referred by the audit manager to the Managing Director."

A third attack on the problem can come through a more constructive audit approach in which the auditor provides auditees with suggestions which help them to recognise their own problems and inefficiencies; and a more determined joint effort with the auditee to work out needed corrective action is conducted during the course of the audit - and this introduces us to the discussion of other reporting characteristics.

(ii) The statement of audit objectives and scope

Audit reports are on a wide variety of subjects. Therefore, an explicit statement of the specific audit objectives and scope should be contained in the audit report. The specific objective refers to the general idea of the audit approach and the nature of the particular audit assignment (e.g. regular examination or special audit project). The scope statement has its importance specially in identifying any limitations of the examination made - that is the areas which were not

covered, and the areas which, because of the very title of the report, the reader would consider covered in the audit unless the scope statement showed otherwise.

When asked to indicate their opinion concerning this reporting practice, 79% of audit managers agreed that an expression of the specific audit objectives and scope should be contained in the audit report, whereas 8.5% were uncertain, and 12.5% disagreed. The calculation at ".95 level of confidence" has produced a 2.47 to 2.87 confidence interval for the average of the population response on the three-point scale used, which suggests a high degree of agreement with this sort of reporting practice between internal auditors (see Table (7.11)).

A follow-up of this point during the investigation of audit reports has revealed that the statement of audit objectives in particular is always emphasised in non-repetitive type audits (i.e. when the audit is identified as a response to special management request).

In cases of regular or routine examinations, the audit objective is not often stated in the audit report on the ground rule, as pointed out by audit managers interviewed, that there is no need to repeat the same objectives in each regular or routine audit report.

It is also recognised that unless it was a special audit assignment, audit steps were described in general terms as part of the scope statement. Also there was no indication of any particular auditing technique being followed and referred to in the scope statement contained in the audit report (see Q.1(i),(ii) and (iii) in Appendix (D)).

(iii) The statement of opinion

Based on the results of his review, the internal auditor should be able to prove his professional judgement for the activities he has reviewed. This is the most natural demand that is expected from an internal auditor by all management levels. Needless to say, the failure to do so deprives management of an important audit service.

Accordingly, it has been suggested that the audit report should contain a summary of the audit findings and an expression of the auditor's overall opinion concerning the area under review. As shown in Table (7.11), 96% of audit managers responding are in agreement with this suggested reporting practice, and only 4% are uncertain. With .95 confidence, this audit reporting practice is expected to be generally followed by internal auditors.

Further investigation of audit reports has disclosed that all audit reports examined do include a statement of the auditor's overall opinion or general conclusion concerning the audited area. The summary of audit findings and the auditor's opinion made are generally responsive to (a) the topic of the report and (b) the audit objectives spelled out in the report. This conclusion is reached through the examination of audit reports in relation to detailed audit programmes for each audit and other related working papers (see Q.5 in Appendix (D)).

The following quotations taken from audit reports are illustrative examples:

Special audit assignment.

Audit of Client Bill/Pay Procedures - Donovan Data System.

"We have performed a review of the use of the D.D.S. in the billing and paying operations for ... & ...

Our review included an evaluation of the controls in the systems, certain tests to ensure the controls were in operation, and a review of the procedures being used in the Billing Department.

Generally we found the controls in the system to be adequate except for the points mentioned below.

... .."

* * * *

Routine audit reports.

"In accordance with our agreed upon arrangements we have completed an audit of ... Company.

The review procedures included, to the extent considered necessary, the examination of selected areas of the company's activities, review and evaluation of certain internal controls and operating procedures, and comment on the reliability of the management returns.

From our review we have formed the opinion that, with the exceptions mentioned in this report, the arrangement made by management for internal control have been suitable for the needs of the business and have operated satisfactorily."

* * * *

(iv) Proper consideration for auditees

Among the important aspects of the reporting phase are the steps taken by the internal auditor to validate the adequacy of the reported findings and the soundness of related recommendations prior to the finalisation of

the audit report. In fact, the basis for this validation is the audit work and appraisals that are carried. However, this needs to be supplemented by specific types of review and confirmation involving auditee personnel.

The benefits of this supplementary validation are twofold. First, it provides a cross check on the adequacy of the audit work in general and the validity of audit points made in particular.

Second, and even more important, this review induces a partnership relation with auditees. The opportunity for this sort of participation creates both a co-operative spirit and a more likely commitment to working out adequate solutions for problem areas.

Under the opposite approach there is the very real possibility that local management may be embarrassed and embittered by having their superiors informed of audit results at the same time or before they themselves are informed, through the medium of the final audit report. Such developments will then cause the auditee to have a defensive and hostile attitude toward working out needed solutions. The internal auditor is also likely to find a non-co-operative auditee when he comes back for another audit.

For these reasons, it has been suggested that audit results should be reviewed with auditees before the final report goes to a higher level in order to minimise the possibility of misunderstanding. It is also suggested that the auditee's views about audit points made may

also be incorporated into the audit report.

Table (7.13) shows that 94% of audit managers indicated that they follow the reporting practice of reviewing drafts of audit reports with auditees before submitting the final report to higher levels, and only 6% stated that they do not put this into practice. The average of the population response to this question is between .87 and 1.0 on the two-point scale used at .95 confidence, which suggests a high degree of applicability as to this reporting practice.

In effect, the review of draft reports with auditees before the final report goes to higher levels represents a good opportunity for the internal auditors to demonstrate the constructive and professional type of service he is seeking to provide. This is particularly true when the review results in suggestions or indications of the needed corrective action the auditee intends to take.

95.6% of audit managers stated that indications of the corrective action the auditee intends to take are frequently established as a result of reviewing draft reports with auditees. With .95 confidence this is *often* happens in actual practice (see Table (7.13) item (i)). The review of draft reports with auditees also has merit through as it demonstrates genuine consideration for the auditee.

Yet, it has some potential disadvantages. For instance, there is a possibility that the internal auditor

becomes the captive of the auditee regarding the way in which particular words are used and audit findings are presented. This may lead to another disadvantage, that is the possibility of an excessive delay in finalising the audit report.

Changes in the report's wording frequently happen as a result of reviewing draft reports with auditees. As shown in Table (7.13) item (ii), this is acknowledged by 97.8% of audit managers responding. With .95 confidence, this is only limited to *sometimes* frequency in actual practice, however. Table (7.13) item (iii), shows that 97.8% of audit managers stated that adjustments to audit findings made might occur as a result of reviewing draft reports with auditees. On average, however, this only *sometimes* happens in actual practice with .95 confidence.

While reviewing draft reports with auditees represents one of the steps taken to validate audit findings, in some organisations there may be a further way in which this validation is effected through what is called the "closing conference" or "action meeting". This is revealed from the comments provided by audit managers on the question stated in Table (7.13). Also, more information about this internal audit reporting practice was gleaned during interviews with audit managers.

This "action meeting" often takes place at the close of the field work, just preceding the planned departure of the field audit personnel. In most instances, it includes the senior members of the audit group and the

Table (7.13)

Review of Draft Reports with Auditees

* Are drafts of internal audit reports reviewed with auditees before the final reports goes to higher level?

Scale	Answer	NVC	Pct.	Cum.Pct.
1	YES	45	94	94
0	NO	3	6	100
		48	100	
Mean: .94 S.D.: .26 .95 C.I. .87 to 1.0				

* If 'YES', how does this affect the reported findings and recommendations:

(i) Indication of the corrective action the auditee intends to take?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	14	31	31
4	Mostly	10	22.3	53.3
3	Often	9	20	73.3
2	Sometimes	7	15.6	88.9
1	Seldom	3	6.7	95.6
0	Never	2	4.4	100
		45	100	
Mean: 3.43 S.D.: 1.47 .95 C.I. 3.0 to 3.86				

* See Q.17 (a) and 17 (b) in Appendix (B).

continued / ...

Table (7.13)

Review of Draft Reports with Auditees

(ii) Changes in the report's wording

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	2	4.4	4.4
4	Mostly	4	8.8	13.2
3	Often	8	17.7	30.9
2	Sometimes	20	44.6	75.5
1	Seldom	10	22.3	97.8
0	Never	1	2.2	100
		45	100	
Mean: 2.22 S.D.: 1.11 .95 C.I. 1.90 to 2.54				

(iii) Adjustments to findings?

Scale	Answer	NVC	Pct.	Cum.Pct.
5	Always	2	4.4	4.4
4	Mostly	2	4.4	8.8
3	Often	3	6.7	15.5
2	Sometimes	22	49.0	64.5
1	Seldom	15	33.3	97.8
0	Never	1	2.2	100
		45	100	
Mean: 1.91 S.D.: 1.04 .95 C.I. 1.61 to 2.21				

top members of local management. At the meeting main audit findings and proposed recommendations are reviewed. If there is no agreement between audit personnel and auditees both sides of the argument are included in the audit report and a higher level authority then settles the issue.

Based on the researcher's observations during investigating audit reports, the auditee's views about audit points made are often included in audit reports. This is done, in some cases, by providing special space in the body of the report in which the auditee's comment concerning each particular audit point is stated. In other cases, the auditee's views are discussed in the report and his written comments are often attached as an appendix thereto.

A good indication that auditees in the organisations responding have a high degree of familiarity with the work of internal auditing was obtained from auditees themselves. A question was structured to reveal how executive managers obtain information of internal audit findings and recommendations, this indication was available. A summary of their responses to this question is presented in Table (7.14). For a meaningful comparison between the answers obtained with respect to each item introduced in this table, a confidence interval was constructed for the calculated average of the answers obtained in each case at .95 level of confidence.

Based on the results obtained, it appears that discussions between auditors and auditees at the end of the audit represent the main stage at which audit results are most frequently communicated to auditees. The average of the population response to this particular reporting practice falls under the *often* to *mostly* range of frequency, the highest in Table (7.14). Information of audit results through the medium of the final audit report comes second within *sometimes* to *mostly* range of frequency. Informing auditees about audit results either during the course of the audit and/or through the medium of draft reports come in the third place with frequency ranging from *sometimes* to *often*. It can be recognised also that informing the auditee about audit results through his superior after the audit is *seldom* followed as a way of communicating the results of the audit to auditees.

With particular reference to this latter result, Table (7.14) shows that 61% of the respondents stated that they never obtain information about audit results from their superiors after the audit. Bearing in mind that approximately one quarter of the sample units (i.e. executive managers) belongs to administrative and upper executive levels in the organisations responding, this is to a certain extent understandable (see Table (3.3)).

Since these results are obtained from executive managers who are mainly responsible for the operational activities in their organisations, it seems reasonable to conclude that internal auditors in these organisations have a high degree of familiarity with the work of those

Table (7.14)

Ways of Informing Executive Managers about Internal Audit Findings and Recommendations

* How do you obtain information of internal audit findings and recommendations:

	Scale						Means	S.D.'s	.95 C.I.
	5	4	3	2	1	0			
	Always	Mostly	Often	Some-times	Seldom	Never	Percentages		
1. from discussions with internal auditors <u>During</u> their audit	33	10	28	14	10	5	3.3	1.55	2.6:3.9
2. from discussions with internal auditors at the <u>End</u> of their audit	42	28	10	10	-	10	3.8	1.58	3.1:4.4
3. from internal audit <u>Report Drafts</u>	23	19	14	14	10	20	2.8	1.87	2.0:3.6
4. from the <u>Final</u> audit report	48	14	5	-	5	28	3.1	2.24	2.2:4.1
5. from my superiors <u>After</u> the audit	10	5	-	10	14	61	1.0	1.67	0.6:1.4

* See Q.5 in Appendix (C).

executive managers - another indication of the expanding scope of internal audit into operational areas.

(b) Finalisation of audit reports

To some extent audit findings will be known to the organisation's personnel at the field location as the audit work progresses.

It will be desirable to inform operational personnel of the audit findings so that the organisation's interests can be protected by prompt corrective action. However, what is usually at issue is the judgement of how significant the particular audit findings are, and the extent to which those findings and related recommendations should be communicated to higher levels of management.

Needless to say, much depends on how serious the situation is and the recommended action will be protective to the extent warranted and constructive when it emphasises more the objective of finding a better way to do whatever is involved.

Yet, there is the question of how often audit reports, or any portion of them, should be communicated to senior management. Based on the results shown in Table (7.15), it appears that communicating audit reports to management above the level of the audit area is commonly followed by internal auditors. 94% of audit managers indicated that this reporting practice is carried out in their organisations. The extent to which this audit reporting practice is regularly carried out ranged from 76%-100% at .95 confidence coefficient (see Table (7.15) item (i)).

Table (7.15)

Regularity of Communicating Audit
Reports to Senior Executives

* Are internal audit reports regularly communicated to senior executives (i.e. to management above the level of the audit area)? If 'YES', how often %?

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
1	25% or less	1	2	2
2	26% to 50%	2	4	6
3	51% to 75%	4	8	14
4	76% to 100%	38	80	94
0	NO	3	6	100
		48	100	
Mean: 3.52 S.D.: 1.11 .95 C.I. 3.21 to 3.83				

* Are periodic summaries of significant findings prepared for these executives? If 'YES', how often %?

Scale	Answer	NVC	Pct.	Cum.Pct.
YES				
1	25% or less	1	2	2
2	26% to 50%	2	4	6
3	51% to 75%	5	11	17
4	76% to 100%	24	50	67
0	NO	16	33	100
		48	100	
Mean: 2.42 S.D.: 1.83 .95 C.I. 1.90 to 2.94				

* See Q.19(a) and Q.19(b) in Appendix (B)

In addition to the communication of complete audit reports there is the possibility that supplementary, special, periodic summaries be prepared for senior executives in the organisation. The purpose of such digests is to provide summary information of significant audit findings without requiring actual reference to the complete report. This approach is particularly applicable when the complete reports are very complicated and voluminous.

Table (7.15) shows that 67% of audit departments responding are adopting this reporting practice, and one-third of the audit departments are not. The extent to which this reporting practice is regularly carried out in the organisations responding ranges from 26% to 50% at .95 level of confidence which suggests a moderate degree of applicability.

(c) Post report activities

While a great deal of the internal auditor's influence is during the course of the audit and prior to the finalisation of the formal, final audit reports; there is much that is done subsequent to the completion of these reports.

One of the important aspects of post report activities is the follow-up of audit reports. This is specially significant when management requests this follow-up role as an effective means to ensure that needed corrective actions based on the audit are actually taken.

The desirability of follow-up activity in itself is

very clear. The problem, however, is who is responsible for the corrective action needed and, hence, follows up its progress? Based on the results shown in Table (7.16), the primary responsibility for corrective action is left to the auditee manager and his superior in 84% of cases. This responsibility is carried out by other management members in 8% of cases. Respondents who stated so indicated that the responsibility for corrective action is sometimes attached to the Managing Director (2%), Director Finance (2%), auditees and the Methods & Systems Department of their organisations (4%). In these cases the audit department acts as consultant. In 6% of cases, corrective actions are considered to be the responsibility of the audit department jointly with the auditee and his superior, and only in 2% of cases the audit department is solely held responsible for carrying out needed corrective action.

The internal auditor might be in a position where he is best able to determine both cause and cure of the problem. Here, a joint effort between the auditor and the auditee seems to be reasonably practical and may be beneficial to the organisation. However, the move to being *responsible* rather than *assisting* can undermine the basic responsibilities of the managers who are in charge of the particular activities. It also puts the internal auditor more in the role of a policeman, and this tends to conflict with his ongoing partnership relating with the auditee. It may also be said to

Table (7.16)

Responsibility for Corrective Actions
After the Release of Audit Reports

* After the release of the audit report, who has the primary responsibility for correction action:

	NVC	Pct.
● Internal Audit Department?	1	2
● The Auditee Manager and his Superior?	40	84
● Internal Audit Department Jointly with the Auditee Manager and his Superior?	3	6
● Other, please specify ..	4	8
	<hr/>	<hr/>
	48	100
	<hr/>	<hr/>

* See Q.22 in Appendix B

compromise the internal auditor's independence to become involved in the implementation of his audit recommendations.

The results shown in Table (7.16) clearly indicate that the internal auditor usually play no specific role after his report is released, other than to respond to questions and to make sure that recommended corrective actions are acted upon in an appropriate manner, and to review the situation again at the time of the next audit assignment.

Such being the case, should the internal auditor recommend in his report appropriate officials to carry out corrective actions? In response to this question, 79% of audit managers agreed, 10.5% were uncertain, and 10.5% disagreed (see: Table (7.11) item (4)).

In general, this particular reporting practice is expected to be agreeable between internal auditors with .95 confidence (see Table (7.11)).

(d) Professional criteria of good reports

Reference has previously been made to the particular features that are important in a report that will be adequate. In doing so, special emphasis has been placed upon items relating to the substance of the report. Here the focus is on the general features that are important in presenting a report that is readable, understandable, and persuasive.

In order to facilitate the gathering of practical evidence which relates to this aspect of the reporting phase, audit managers were asked whether they evaluate the quality of their audit reports and on what basis they

do so in order to get a fair picture of the quality of work done.

With reference to the first part of this question, 75% of the respondents replied in the affirmative and 25% answered in the negative. However, among those who answered positively 10% of the total answers did not respond to the second part of this question. (See: Q.18 (a) and (b) in Appendix (B)). Reasons given for this may be cited as follows:

"This is too subjective to have standards or measures."

"None- done by 'feel'."

"None as such - my judgement is entirely subjective."

"No stated standards. Generally one attempts to contribute the most good to the company's welfare making the report as significant, as clear and as brief as possible, in that order."

Nevertheless, the general criteria of good reporting as perceived by audit managers who answered this question in addition to their comments provided were investigated, analysed, and classified in terms of their importance under the following categories:

1. Personal skill in communication

The efficacy of an internal audit department depends very largely upon the relationship that exists with all those with whom it comes into contact. In this context, it has been said that the most important characteristic of an internal auditor is his power in displaying "indirect executive ability", that is, his success or otherwise in persuading senior staff to act on his recommendations. The measure of such success is in direct proportion to his ability to work with people.

Most audit managers place great emphasis on the internal auditor's personal ability and experience in communicating with auditees on a personal though professional basis as vitally important in the total reporting process.

Included here are:

- a. professional tone - this professional tone avoids excessive casualness on the one hand and stilted formality on the other. The auditor presents a report that will build respect for the audit department's effort. The professional tone reflects dignity, perspective, and objectivity.
- b. courtesy and tact - The auditor needs to remember that people involved in the audit points made will be very sensitive as to any reflection upon their performance. The auditor, by being courteous and tactful, can do much to neutralise this sensitivity.
- c. Persuasiveness - everything that is included in the audit report should be presented in a manner that will provide the proper setting and subsequent motivation to take the needed types of action. The key words here are logic and fairness.
- d. Consideration - the audit report should show proper consideration for auditees through reporting favourable conditions and should not focus exclusively on the negative aspects.

2. Relevance and reliability

The content of the audit report should be relevant to the total audit assignment and the specific purpose of the audit review. Individual statements and related data included must be accurate and reliable. The particular matters with which the internal auditor should be concerned, as indicated by audit managers responding, would include:

- a. Acceptance of, and working to, management policy statements.
- b. Comparison with working papers. (These two points directly pertain to relevancy of audit reports).
- c. Sample size and tests of errors included.
- d. Review of audit reports by another person who was not working on related audit assignment.
- e. Using audit report formats and approach used in similar reports. (These last three points directly pertain to reliability of audit reports).

3. Standards of Presentation

Other standards applicable to audit report concern matters of presenting audit reports in a manner which will facilitate reading and understanding. These include the use of appropriate words, headings, spacing, and adequacy and clarity of explanation. This includes brevity to ensure it is read, in addition to adequate standards of neatness and legibility. It is usually regarded as important that audit reports are produced to

a standard equal, but not excessive to, that expected by management of important internal management reports.

In the foregoing analysis and discussion reference has been made to those reporting characteristics pertaining to substance and those pertaining to good reporting in general. In addition to the questionnaire responses, the researcher has actually received many comments which relate to criteria of good reporting. A comment which summarises the main points of the previous discussion was provided by the audit manager in a large organisation. In this comment, the internal audit reporting phase in this organisation was explained as follows:

"Reporting

General Requirements

Reporting to management is one of the most important part of the audit task. The report will be written as an aid to management and must not be interpreted in any way as being critical of their activities or as displacing their authority. It should provide management with a balanced opinion sufficient to enable them to take whatever corrective action is required. The internal audit reports will be prepared as soon as possible after the work has been completed and efforts will be made to ensure prompt action is taken by management. The degree of detail included in the reports will be appropriate to the level of management to whom the report is directed.

Contents of Reports

Reports should be concise, clear, factual and to the point. They should state the nature of the deficiencies identified, the effect that each of these has had or could have had and the auditor's recommendation to overcome it. Points should be discussed as they arise with the appropriate level of management in the function concerned to establish the accuracy and relative merits of the points raised together with any proposed action to be taken. Replies to audit queries and reports should be produced by the management of the area concerned within a reasonable

time following their submission. These replies should state that action which is to be taken on the matters raised. The internal auditor should follow up at his next audit to ensure that appropriate action has in fact been taken on the points raised.

Circularisation of Reports

The report will normally be addressed to the Director in charge of the department or section being audited.

Copies will be sent to the Chairman and the Director of Finance and Administration.

A copy of each report will be available, together with the relevant working papers, for the external auditors. These reports will not be sent to the external auditors but will be retained until such time as they arrive to carry out their interim or final audit."

7.3.2 Training services

Among other types of constructive audit services, which are important in terms of overall company benefit, is the extent to which the internal audit department is developing its personnel and making them available for other company needs. When this is being done there is the greater conviction that the internal audit department is making a major contribution to the total company operations. There is also the logical conclusion that the personnel still in the audit department are persons of the same high calibre.

All audit managers interviewed reported that it is a general practice in their organisations to use the audit department as a training group for management and supervisory positions; and this type of training service is provided on an overall company basis (i.e. not confined to audit personnel). They further indicated that this audit service may take the form of interchanging

personnel between the audit department and other departments in the company, (see: Q.3. in Audit Managers' Interview Schedule - Appendix (D)).

Using a larger sample, the I.I.A.'s Survey of Internal Auditing in the U.K., 1976 indicated that 48% of the organisations responding stated that they had an in-house training programme for internal auditors, and 80% of the respondents reported that audit staffs are encouraged to acquire professional qualifications to fit themselves for future line positions - Table (7.17).⁽⁸⁾

7.3.3 Services in connection with external auditing

Another type of internal audit contribution to the organisation can in some situations be the extent to which a more coordinated effort is achieved with external auditing.

All audit managers interviewed reported that both internal and external audits are coordinated to achieve greater company service. They also pointed out that this coordination may be achieved in several ways, one of which is through making use of the audit work actually carried out by external auditors and/or the restriction of external audit work in areas covered by internal audits. Interviewees further indicated that in some situations they try to maximise the external audit services to their organisations through legitimately

8 Smallbone, M.J. (1), op. cit., pp.30-31.

Table (7.17)

Other Internal Audit Services

'Training'

* Do you have an in-house training programme for Internal Auditors?						
Answer:	No reply	%	YES	%	NO	%
	15	6	119	48	115	46
* Do you encourage your audit staff to acquire professional qualifications to fit them for future line positions?						
Answer:	No reply	%	YES	%	NO	%
	21	8	200	80	28	12

Table (7.18)

Other Internal Audit Services

'Savings Relating to Coordination with'

External Auditors'

* Are Internal and External Audit co-ordinated to reduce the amount of time spent by the External Auditors?						
Answer:	No reply	%	YES	%	NO	%
	14	6	196	79	39	15
* Are copies of Internal Audit Reports circulated to the External Auditors?						
Answer:	No reply	%	YES	%	NO	%
	15	6	184	74	50	20
* Do Internal Auditors receive copies of the External Auditor's Reports?						
Answer:	No reply	%	YES	%	NO	%
	14	6	196	78	39	16

* Source: The I.I.A., Research Report No.1, "A Survey of Internal Auditing in the U.K.", (The I.I.A., U.K. Chapter I.I.A. Inc., 1976).

exploiting the work of the external auditor by keeping themselves informed as to how the external auditors are doing their work especially in areas such as computer enquiry programs and statistical techniques. Another indication of coordinated efforts between both types of audits is that all audit departments responding reported that they receive copies of the external audit management letters; copies of the final, formal internal audit reports are invariably circulated to the external auditors of their organisations.

The I.I.A.'s Survey of Internal Auditing in the U.K., 1976 has also come to the conclusion that there exists a consistent pattern of coordination between the two sets of audits. 79% of the organisations responding to this survey stated that internal and external audits are coordinated to reduce the amount of time spent by the external auditors. 74% of these organisations indicated that copies of internal audit reports are circulated to the external auditors and 78% of them reported that they receive copies of the external auditors' reports⁽⁹⁾ - Table (7.18). See also Q.4. in Audit Managers' Interview Schedule - Appendix (D).

9 Ibid., pp.26-27.

CHAPTER 8

AN INTEGRATED PICTURE :

SUMMARY OF RESERACH FINDINGS, CONCLUSIONS, SUGGESTIONS FOR FURTHER RESEARCH

This research has addressed itself to the study of the nature of internal auditing, with the specific objective of investigating the management functions and the management levels at which internal auditing both attempts to, and succeeds in, providing a service, the nature of that service, and to provide explanations.

To achieve this objective, certain conceptual criteria which relate to various internal audit activities were first identified as a basis for approaching the study. These criteria were defined as follows:

1. The functional areas actually to be reviewed - i.e. financial versus non-financial areas.
2. The management levels at which the review is conducted, such as Administrative-, Executive-, and Lower Managerial-level.
3. The general features of the particular audit service provided - i.e. protective versus constructive audit services - See: Sec. 2.5.

Accordingly, three main research areas were identified to be empirically explored under the following headings:

1. Internal audit coverage by management function,
2. Internal audit coverage by management level, and
3. The nature of internal audit points made to management -
See: Sec. 2.6.

The principal sources of information used to cover the research inquiry were:

- (i) Questionnaire for the investigation of audit reports - Appendix (D).
- (ii) Internal audit managers' Questionnaire - Appendix (B).
- (iii) Questionnaire for executive managers - Appendix (C).
- (iv) Interviews - Appendix (D), observations, and published data, see also Sec. 3.1 et seq.

To proceed with the plan of empirical research, each research area has been divided into a set of basic research hypotheses, and each hypothesis was also divided into a set of variables. All questions in the questionnaires used were then converted to these variables and finally linked with relevant research areas and hypotheses - see Appendix (E).

The statistical analysis and testing of the information obtained were carried out on the City University's link with ULCC using the SPSS version 6.52, 1977 - see Sec. 3.2.

The findings and conclusions disclosed by this research are arranged in the following sections under the same headings of research areas.

8.1 Firstly: Internal Audit Coverage by Management Function

In accordance with the objective of the study, this research area was identified to investigate the nature of internal auditing as seen from the standpoint of the functional areas actually reviewed - i.e. financial versus non-financial aspects.

The empirical research was developed to seek answers to the following two main questions:

- (i) Does the scope of internal auditing actually extend into non-financial operational areas.
- (ii) What are the main factors which have a bearing upon the effective functioning of internal auditing in this respect?

Corresponding research findings may be cited as follows:

8.1.1 The type of emphasis has shifted to the more non-financial aspects of the areas under review.

Internal auditors have extended their scope to a review of controls in operational areas; no longer does there seem to be a preponderance of emphasis on accounting and financial matters in the performance of internal auditing. Yet, this does not necessarily mean that either audit effort or effectiveness in reviewing the financial aspects of the operations audited has decreased, but rather the scope of audit coverage and the type of emphasis has shifted to include more non-financial aspects of the operations within audit's purview. The empirical evidence indicates that: There exists a majority agreement (88%)

between audit managers responding that the scope of internal audit work has extended into non-accounting and non-financial aspects related to tasks of the managers responsible for operational activities in their organisations (i.e. executive managers), see Table (5.2) item (2). Approximately half of operating officials (i.e. executive managers) responding considered internal auditing worked on both financial and non-financial aspects of their tasks - Table (4.8), and more than four-fifths of internal audit departments responding were involved in an evaluation of overall performance of various operating departments in their organisations - Table (4.4). Nearly one-third of the use of internal audit staff time in the organisations responding was devoted to internal control reviews which have a requirement to audit non-financial aspects of the functional areas under review, see: Sec.4.2.

8.1.2 Upward trend toward audits of non-financial areas

The development of internal auditing into a concern for a review of controls in operational areas is moving upward. Worldwide, it appears that internal auditing has evolved to embrace the review of all operations, not merely accounting and financial matters. By 1968 only one-fifth of internal audit departments restricted their reviews to accounting and finance and by 1975 this had dropped to 2% . By 1975 only 48% of internal audit work was devoted to financial and accounting audits, the remainder being classified as operational auditing.⁽¹⁾

1 The I.I.A. (7), op. cit., p.9.

These figures are crude in that they (i) do not distinguish between the types of data being reviewed in operational areas - i.e. financial versus non-financial audit data, and (ii) they were based on a questionnaire only and the responses were not analysed in a statistically valid way. In the study which is the subject of this thesis, an analysis of internal audit effort in terms of financial versus non-financial audit recommendations made to management in the organisations responding over a period of five years disclosed that 12%, 33% and 55% of financial audit recommendations made in 1973/74, 1975, and 1976/77 consecutively compared with 5%, 30%, and 65% of non-financial audit recommendations made in the same periods respectively, see: Sec. 4.1.2 esp. Table (4.2). Other sources also allow the conclusion that operational audits (where the data reviewed is non-financial) have increased significantly between 1971 and 1976, and now account for 44% of internal audit effort⁽²⁾ - see Table (4.7).

8.1.3 The functions audited

The functions most frequently audited in the organisations responding are:

1. Purchasing - extensive.
2. Safety, Security, and Insurance - extensive.
3. Stock control - moderate.
4. Personnel - moderate
5. Production planning and control - moderate.
6. Quality Control - little (see: Sec. 4.1.3)

2 San Miguel, J.G., et al, op.cit., pp.5-11.

8.1.4 Approaching operational auditing

Approaching operational audits refers to the problem of the various ways the internal auditor can define the scope of his review. The issue here is whether the review shall deal with a given function (i.e. functional audit style) or with the total operational responsibilities of a given organisational entity (i.e. departmental audit style).

A functional audit is confined to one subject or process, it may cut across organisational lines and literally follows the function wherever it is performed throughout the organisation - e.g. the audit of the launching of a new product, or the security audit. A departmental audit selects for review all activities in the control of a given managerial position and may therefore involve a review of several unlike subjects - e.g. the audit of an entire company, division, or other operational unit. Both functional style and departmental style reviews can vary greatly in complexity depending upon the volume of operations and the number of people involved. While most internal auditing reviews have the character of either a functional or departmental style - both used in approximately all audit departments responding (Tables (6.3) and (6.4) - many reviews will also have a defined scope which is determined by the specific request of management or the specific audit research that the internal auditor has set for himself. The 'management studies' style, when a top-notch internal audit team participates in special studies involving an evaluation

of, and offering recommendations for improvements in, problem areas of the business, was also used widely (88%) in the audit departments responding, though less frequently than both functional and departmental audit styles - Table (6.5). Thus, in the final analysis, the scope of a particular review is determined by a combination of what management wants and what is manageable from the standpoint of the internal auditor - see: Sec. 4.1.3 and Sec. 6.2.

8.1.5 The nature of audit performed in operational areas

Internal auditing is also evolving from attesting compliance with laid down procedures to one which is also concerned with operating efficiency and effectiveness, though slightly over three-fifths of total audit effort in evaluating operational areas, as pointed out by audit managers responding, is directed towards audits of compliance and just under two-fifths of total audit effort is concerned with reviews and appraisals of performance aspects relating to operational efficiency and effectiveness. The fact that should be recognised, however, is that compliance audits are no longer permitted to dominate the internal audit approach - see: Table (4.5).

8.1.6 Significant factors in the performance of operational audits

The empirical evidence suggests that the following are significant factors in determining whether internal audit departments tackle operational audits:

1. The organisational reporting level of the internal auditor.
2. The size of the internal audit department within an organisation.

3. The number of other non-accountant auditors employed within an internal audit department, and
4. The size of the organisation.

In this context, the empirical evidence has disclosed:

- (a) The extent to which performance aspects of various operating departments in the organisations responding are audited is significantly correlated with the organisational reporting level of the internal auditor - see: Sec. 4.6.2 and Table (4.14).
- (b) When the internal auditor reports to a higher managerial level outside the ambit of the finance function (i) more emphasis seems to be placed upon evaluating operating performance in general, and (ii) performance aspects which relate to operational efficiency and effectiveness are more liable to be subject to internal audits in particular - Table (4.15).
- (c) Internal audit's involvement with reviewing and evaluating operating departments within the organisations responding tends to enlarge with the increase in the percentage of active audit staff employed (i.e. audit employees with the exception of clerical and secretarial audit staff as a proportion of the total employed in the company), and this enlargement reaches its highest scores when the percentage of active audit staff was close to the 'one auditor per one thousand employees criterion', see: Table (4.23).
It was recognised, however, that the percentage of active audit staff varies not only according to the size of the organisation as expressed by the total

number of employees but also according to the main industry group to which the company belongs - see: Table (4.18). It would appear, therefore, that the percentage of active audit staff is but one variable in determining the numerical adequacy of internal audit staff in the company; the objective and scope of the audit department concerned, the nature of the particular operational activities under review, the travel load for internal audit staff, the number of special assignments requested, and the problems of maintenance of qualified audit staff - all have an impact (see: Sec. 4.6.3).

- (e) The empirical evidence shows the monopoly, though a weakening monopoly, of the accountant in the field of internal auditing. Approximately three-fifths of the total number of internal auditors employed in the organisations responding had accounting backgrounds whereas the proportion of non-accountants employed as auditors is 31% of the total number of internal auditors in these organisations, the remainder being classified as clerical and secretarial audit staff - Table (4.19). This accounting bias is also evident from the fact that over two-fifths of the organisations responding still only use accountants in their audit departments, and a further 27% of the organisations concerned have more with accounting backgrounds than all other backgrounds put together. Only 8% of the organisations responding use non-accountants exclusively in their audit departments,

and just under one-fifth of the organisations concerned have more non-accountants as auditors than the accountants in their audit departments - Table (4.20). Other evidence on the monopoly of the accountants in the field of internal auditing is that the vast majority (87.5%) of the heads of internal audit departments in the organisations participating in the study have accounting backgrounds or experience. The corresponding share of non-accountants in the leadership of internal auditing is only one eighth - Table (3.7). It must be recognised, however, that the audit department within the company can never be expected to have specialists in every type of operational activity. What is sought, however, is a reasonable balance. Yet, the empirical evidence does suggest that with the use of non-accountant specialists as auditors in the company, internal audit departments would be better able to extend the scope of their activity into operational areas outside accounting and finance - see: Sec. 8.2.5.

- (e) An inverse, weak but statistically significant correlation is detected between the size of the organisation - as expressed by the total number employed - and the scope of internal audit work in operational areas - Table (4.21). It would appear, therefore, that a smaller organisation, where management finds it easier to control, would enable internal audit to concentrate on operational auditing

to a greater extent - Table (4.22). In a relatively larger organisation, internal audit seems to be less involved in operational auditing due to the problems of large size (i.e. less frequent and/or less thorough coverage of the audit areas). Probably, because of this and because management finds it less easy to achieve control, internal audit effort seems to be directed more toward compliance audits, see: Tables (4.5) and (4.22). In the largest organisations, internal audit's involvement in operational audits tends to increase. This could be due to the greater need of management at higher levels to know more about operational areas, many of which are often scattered over increasingly large geographical areas and therefore management relies upon its internal auditors to report details and supporting evidence concerning the efficiency of these widespread operational areas. This could also be due to the ability of the largest organisations to employ a significant number of non-accounting technical specialists within their audit departments to cope with the problems of reviewing the technical aspects of the operations under review - see: Table (4.22), see also Sec. 8.2.5 hereafter.

8.2 Secondly: Internal Audit Coverage by Management Levels

Another way to look at the nature of internal auditing is to investigate the level in the organisational hierarchy to which the internal auditor is able to go in terms of

the scope of his review and appraisal; the second research area of the study was developed to cover this inquiry.

The empirical research was devoted to seek answers to the following specific questions:

1. What levels of the organisation are actually audited?
2. What aspects of operational areas are reviewed at each management level?
3. What are the main limitations upon internal audits at the various management levles?

Corresponding research findings could be summarised as follows:

8.2.1 The extent of internal audit's permeation in the entire organisation

The levels of management whose work is subject to internal audits are mainly executive and lower managerial levels. Administrative levels are sometimes subject to internal audits but its doubtful that they are subjected to true or effective internal audits in the organisations participating in the study. In this respect, the empirical evidence has disclosed the following:-

- (a) All audit managers responding reported that lower managerial levels in their organisations are subject to internal audits, and with .95 level of confidence this is *always* the case - Table (5.1).
- (b) All audit managers responding reported that executive levels in their organisations are subject to internal audits, and with .95 level of confidence this is *often* the case - Table (5.1).

- (c) 71% of audit managers responding indicated that administrative levels in their organisations are subject to internal audits but with .95 level of confidence this is only *sometimes* happens. Moreover, topmost managerial positions (i.e. chairman, vice-chairman and/or president and vice-president) are excluded in one eighth of cases and nearly one-third of the respondents revealed that their responses should be interpreted as applying only to administrative levels of the local managements - Table (5.1), see also Sec. 5.1.1 and 8.5.2(a).
- (d) Internal audit time is inversely proportional to the levels of management in the organisations responding. This is evident from the fact that over half of audit recommendations made to management in these organisations are concerned with tasks of lower managerial levels, more than one-third commented on tasks of executive levels, and only one-tenth of internal audit recommendations made affected administrative levels - Table (5.3), see also Sec. 5.1.2.

8.2.2 Types of audit emphasis at each management level

The scope of audit coverage and the type of emphasis has shifted to a review of controls at organisational levels above that of lower management. More than three-fifths of audit managers responding do not believe that most internal audit work is concerned with the accounting and financial aspects of the lower managerial levels. 88% of audit managers responding agree that the scope of

internal audit work has extended into non-accounting and non-financial aspects of executive levels - another indication of extending the scope of audit into operational areas. There is a further strong agreement (69%) between audit managers responding that internal audit attempts to cope with reviewing tasks of administrative levels - Table (5.2), see also Sec. 5.2.1. Total internal audit effort, in terms of audit points made to managements in the organisations responding, seems to be disproportionately at both administrative and lower managerial levels for financial audits, and at executive levels for operational audits. This is understandable in view of the kinds of interest and the levels of responsibility that the three levels have for these matters - see Table (5.4) and Sec. 5.2.2.

8.2.3 Interpretation of the internal audit 'appraisal'

The expanded role of internal auditing suggests that it is appropriate for the internal auditor to go into any area at any organisational level without any limitation as to the type or amount of audit review to be conducted. As a matter of practice, however, most (81%) of the total audit effort in terms of audit points made to management in the organisations responding, is directed to appraisals of management control systems and only 19% of total audit effort is implicitly directed to evaluations of the quality of individual performance in related audit areas many of which belong to lower managerial levels. (27%) and executive levels (13%); and nothing

pertains to administrative levels, see Table (6.6) and Sec. 6.3.

8.2.4 Should individual performance be appraised?

Most internal auditors have the desire to appraise individual performance but they differ as to the level in the organisational hierarchy at which the appraisal should be conducted. Approximately three-quarters of audit managers responding agree that an appraisal of the quality of performance in carrying out assigned responsibilities should have a place within the internal audit activities - Table (6.1). 71% of those audit managers want to extend their appraisal activity to include an evaluation of individual performance at administrative levels, and 100% of them believe that both executive and lower managerial levels should be subjected to an appraisal of the quality of their performance in carrying out their assigned responsibilities - see: Sec. 6.1 esp. Table (6.2).

Management is generally aware of the benefits that might be gained from the review and appraisal of individual performance as 71% of executive managers responding reported that there is a management system employed in their organisations to evaluate the quality of their performance - Table (6.9)(1). However, it seems that management tends to keep its internal auditor away from this rather sensitive area as 73% of executive managers responding reported that the audit departments in their organisations had no responsibility for performing the evaluation process, and only 27% of them indicated that their audit departments were partly responsible in

this regard - Table (6.9)(2), see also Sec. 6.4.4.1.

Excluding the appraisal of the quality of performance in carrying out assigned responsibilities could also be due to the very nature of the internal auditor's role itself; that is, quality of performance represents an area which is far more subjective than most of other internal audit activities and at once involves a great number of complicated factors; since it directly concerns human beings as individuals it can easily become extremely sensitive.

Therefore, the conventional wisdom of internal auditing is to set limits for the internal auditor's appraisal activity which exclude the evaluation of individual managers not because they are irrelevant from a control point of view but because the nature of the internal auditor role makes it very difficult for the internal auditor to be the person who conducts the evaluation process. This might reduce the value of the internal audit service since the auditor is not looking at all aspects of management performance. However, it might be a reasonable solution for the internal auditor to avoid the ineluctable problems of getting involved in the appraisal of individual performance which in most instances irritate auditees and push them to unfriendly relationships with the internal auditor - see: Sec. 6.4.4.1.

8.2.5 Important factors in auditing management levels

The empirical evidence suggests that the following are important factors in determining whether internal audit departments tackle effectively their appraisal

activities at various management levels:

1. The organisational reporting level of the internal auditor,
2. The size of the internal audit department,
3. The number of other non-accountant auditors employed within the audit department, and
4. The size of the organisation .

In this regard, the empirical evidence has disclosed:

- (a) The extent to which various management levels are audited, and audited effectively, is related to the line reporting relationships of internal auditing and this is most clearly disclosed with respect to audits of administrative levels. For the internal audit function to be effective, first, the internal auditor should be able to bring the activities of various management levels into the scope of his audit and, second, the internal auditor should report organisationally to a higher managerial level than that of his auditee. The empirical evidence shows, on the one hand, lower managerial levels are always subject to internal audits and in most cases executive levels have been brought more frequently into the internal auditor's orbit (see: Table (5.3)). On the other hand, the empirical evidence also indicates that in 85.4% of cases the head of the internal audit department reports organisationally to a senior executive level or higher (i.e. higher than that of auditees) - Table (4.13). Accordingly,

internal auditors seem to be (other factors being equal) successful in conducting effective audits at both executive and lower managerial levels. Administrative levels are *sometimes* subject to internal audits - Table (5.3). Meantime, in 21% of cases where administrative levels are subjected to internal audits, the head of the audit department reports to an officer whose organisational level is *lower* than that of the auditee (i.e. administrative levels) - Table (5.6). In such situations, the internal auditor does not enjoy a higher organisational status which will enable him to conduct an effective audit at administrative levels without being under undue pressure from top level auditees to the extent that could bias the auditor's opinion - see: Sec. 5.3.1.

- (b) A negative, weak, and statistically insignificant degree of association is detected between the number of non-accountants employed as auditors in the organisations responding and the frequency of audit coverage at administrative levels. Yet, a statistically significant, positive degree of association has been observed between the number of accountants employed as auditors in the organisations responding and the frequency of audit coverage at administrative levels - Table (5.10).

As against this, a statistically significant, positive degree of association is detected between the number of non-accountants employed as auditors in the

organisations responding and the frequency of audit coverage at both executive and lower managerial levels - Table (5.1). Accordingly, the use of non-accountant specialists as internal auditors suggests in practice that the internal audit department in the company is better able to tackle audits of executive levels (i.e. operational audits) and this is to be expected in view of the fact that executive levels' main interest is concerned with operational matters to which a review service by non-accountants is evidently needed. However, internal auditors with accounting backgrounds are still playing the main role in reviewing tasks of both administrative and lower managerial levels to whom accounting and financial audits are of greater interest, see: Sec. 5.3.3.2.

- (c) The extent to which various management levels are subject to audits is related to the size of the organisation as expressed by the total number of employees - Sec. 5.3.2. First, a positive weak but statistically significant correlation has been observed between the frequency of audit coverage at administrative levels and the size of the organisation, thus suggesting that higher management levels are more liable to be subjected to internal audits with the increasing size of the organisation. Second, a negative, weak but statistically significant correlation is detected between the frequency of audit coverage at both executive and lower managerial levels and the size of the organisation which suggests

less frequent and/or less thorough coverage of the audited areas at these two levels with the increasing size of the organisation see: Tables (5.7) and (5.8).

- (d) The relative size of the audit department is a significant factor in determining whether it extends the scope of its audit coverage at various management levels. The empirical evidence suggests that all management levels are more liable to be subject to internal audits with the increase in the ratio of active audit staff and this is most likely when this ratio is close to the "one auditor to one thousand employees criterion" - Table (5.9).

8.3 Thirdly: The General Feature of Internal Audit Services

To integrate the total internal audit effort and to provide a basis for an overall appraisal of the nature of internal auditing services, the third and final research area of the study was devoted to investigate general features of the particular auditing activities in terms of various protective and constructive audit services.

To achieve this purpose, the empirical research was developed to include two specific areas of investigation:-

1. The relative emphasis of audit work on past management phases (i.e. historical audits) versus future management phases (i.e. pre-event audits) see: Sec. 2.3.3., Sec. 7.1., see also Appendix (F).
2. The internal auditing reporting phase with special emphasis on the investigation of the nature of internal audit points made to management - see: Sec. 2.3.1, Sec. 2.3.4, Sec. 7.2, see also Appendix (F).

Corresponding research findings may be cited as follows:

8.3.1 Involvement with systems

Consistent with generally accepted audit principles, the responsibility to review and appraise existing management control systems is universally accepted by internal auditors. Some reservations do exist as to the review of newly developed or revised systems and procedures prior to their adoption, and most reservations seem to exist in the area of the actual design and installation of new systems. The empirical evidence shows that:-

- (a) All audit departments in the organisations responding are *extensively* engaged in reviewing existing control systems.
- (b) Reviews of newly developed or revised systems and procedures prior to their adoption are carried out by audit departments in 98% of cases with *moderate* to *extensive* degree of involvement.
- (c) Development and installation of new systems and procedures is performed by the audit departments in 59% of cases with *little* to *moderate* degree of involvement. see: Sec. 7.1.1. esp. Tables (7.1) and (7.2), see also Sec. 7.1.2 esp. Table (7.3). The forward planning systems of the organisations are *seldom* subject to internal audits and thus internal auditors miss a major opportunity to influence future events - see: Sec. 7.1.2.2 esp. Table (7.5).
- (d) The restrictions on the internal auditor's

participation in systems design is largely attributed to the possible threat to his later independence in the review of the subsequent operational actions. The existence of the threat to independence and objectivity must of course be recognised and special care will have to be exercised to see that they are maintained. However, looking at internal audit services within a broader role, the internal auditor's participation in systems design could be seen as more constructive and not as a prejudicial action to the objectivity of subsequent audits especially if the auditor's contribution to the making of the decision at this design stage is important. As the empirical evidence shows, there are some signs of modifications in the established concepts of the internal auditor's independence and objectivity. Participation in the actual development of computerised systems is one indication of the increasing involvement of internal audit in the development of new systems, though its role in this respect appears to be restricted in making recommendations with regard to internal control features which should be incorporated in the proposed systems - see: Sec. 7.1.2.1 esp. Table (7.6).

A further modification of the current concepts of independence and objectivity is where the head of the audit department or one of his senior aides acts in an advisory basis in connection with major management decisions in the field of either current operations

or the forward planning systems of the organisation. 23% of the internal audit departments in the organisations responding reported that the internal auditor is required to appraise corporate plans for a future which has yet to happen - see Table (7.5). Some other audit departments reported that they are preparing their plans for internal auditors to be involved in this area - see: Sec. 7.1.2.2. Other researches reported similar results - see: Table (7.4) and (7.6). Respondents further indicated other involvement, though to a lesser degree, with pre-event audit activities in the areas of standards development and design, production planning, and the total budgetary process - see: Sec. 7.1.2.3 (a) to (e) esp. Table (7.7).

8.3.2. Internal auditors have extended their constructive services

As internal auditors have shifted the scope coverage and the type of their audit emphasis into the more non-financial aspects of the audit areas - Sec. 4.1 et seq - it would appear that they also have transformed their audit service from inspectorial, compliance, and protective auditing (where the auditor's main objective is to protect the status quo in terms of existing policies and procedures) to one which also embraces constructive auditing (where the auditor's main objective is concerned both to evaluate and to improve existing company practice, and may involve audit suggestions and recommendations which are designed to lead to more efficient, effective

or economic methods so as to assist in achieving overall organisation objectives) - Sec. 7.2 et seq.

An in-depth analysis of internal audit effort in terms of protective versus constructive audit points made to management has disclosed:-

- (a) 60.7% of internal audit effort is devoted to make constructive recommendations of which 36.7% included suggestions calling for change in existing controls and/or for better implementation, in addition to 24% which included recommended actions for operating improvements - Table (7.9).
- (b) In comparison with the above, 39.3% of internal audit effort is directed towards making protective audit recommendations of which 29.6% pointed out observed weaknesses in approved controls and 9.7% commented on non-compliance with established protective measures - see: Sec. 7.2.2 and Table (7.9).

8.3.3 Internal auditor's reporting emphasis

The increasing tendency towards constructive auditing is also evident from the internal auditor's perception of the main purpose of internal audit points made to management - Sec. 7.2.1.

- (a) Only 12.5% of audit managers responding agree that the main purpose of audit points made to management is merely to identify problems associated with operations, i.e. pointing out weaknesses.

Identifying the problems within the audited areas *and making recommended solutions* has gained the

majority agreement (98%) of audit managers responding - Table (7.8).

- (b) Only 42% of audit managers responding agree that more emphasis should be placed on the identification of *organisational* weaknesses and making recommendations for their improvements with less emphasis on *procedural* weaknesses and procedural recommendations, though it is asserted that organisational arrangements are the key building blocks of effective management performance and hence organisational weaknesses may be far more serious than procedural weaknesses. It must be pointed out, however, that those audit managers who disagree (58%) expressed the opinion that both procedural and organisational weaknesses are equally important and their identification coupled with the auditor's recommendations for their improvement should be emphasised in the audit report - Table (7.8).
- (c) As a matter of practice, however, it would appear that the relative emphasis of audit work in this respect is placed on the procedural aspects to a greater extent as 50% of protective audit points made to management in the organisations responding commented on procedural weaknesses and 39% of constructive audit points called for procedural changes or improvements, compared with 20% of protective audit points which disclosed organisational weaknesses and 17% of constructive audit points which called

for organisational changes or improvements - Table (7.9).

- (d) As indicated by audit managers responding, internal audit seems to be successful at modifying policies as well as procedures - Table (4.9). As a practical matter, however, suggested modifications or changes in established procedures are more amenable to audit work than recommended modifications or changes in established policies - see: Sec. 7.2.2.1 esp. Table (7.9).

Based on the above results, the following explanations seem appropriate:

1. Policy decisions fall in the category of basic decisions because they govern other decisions and are likely to be relatively permanent and far reaching in their effects. Decisions on organisation structure and design have profound effects on the inter-relationships and activities of people, and such decisions must also be considered basic. In its extreme, this type of decision represents the polar opposite of routine decisions which require relatively little deliberation or which are made repetitively and tend to have only minor effects on the welfare of the business. Decisions of this kind need less rigorous consideration and can more easily be cancelled or reversed. Procedures can be established for making large numbers of routine decisions. Here the internal auditor is on sound ground when he ascertains compliance, or when he goes on to recommend

changes in procedures; and that is why suggested changes in established procedures are more amenable to audit work than recommended changes in organisational arrangements and/or policies - see: Sec. 7.2.2 and (7)(a) in Appendix (F).

2. On the other hand, basic decisions (to which both policy and organisational decisions belong) reside within the sphere of administrative levels; and as the empirical evidence shows (Table (5.1)) these higher levels are only sometimes subject to internal audits - another indication of why internal audit is less involved in making audit recommendations to influence basic management decisions. In fairness to the current state of internal audit practice it must be said that it may lack the necessary expertise or support to be able to contribute to higher level matters.

8.3.4 Attitude of management toward audit points made

The shift of emphasis in internal audit performance from protective to constructive audits is acknowledged and generally appreciated by managements in the organisations responding.

- (a) "Auditors are generally unsuccessful in making audit points which help auditees to recognise their own problems and inefficiencies." 90.5% of executive managers responding have negated this statement - item 1 in Table (7.10).

- (b) "Auditors are generally unsuccessful in making audit points which relate directly to the original objectives of the audit." This statement dissented from by 86% of executive managers responding - item 2 in Table (7.10).
- (c) "The bulk of audit reports relate to weaknesses observed by the auditor (i.e. criticisms) with less emphasis on the strengths observed in management's systems (i.e. praise), with a consequence that auditees consider the auditor to be unfair and unwelcome." Unanimity did not exist as to the implication of this statement. One third of the respondents agreed, 9.5% were uncertain, and 57.5% of them disagreed. One respondent among those who disagreed expressed the opinion that, "The purpose of the audit report is to highlight deficiencies, not to praise systems or the people involved". Another respondent among those who agreed stated that, "I see that the objectives of the audit should be stated clearly and that within these objectives the auditors should positively state that the performance is satisfactory or that specific weaknesses exist, and they should not hint that other weaknesses might exist if this is not substantiated."
- On an overall basis, these results do suggest that the emphasis on pointing out observed weaknesses in audited areas, and the resulting criticisms which might irritate auditees, are no longer permitted to dominate the internal audit approach - see: Sec.

7.2.3 esp. item 3 in Table (7.10).

- (d) The managers whose main responsibilities and interests are concerned with operational activities seem to be fairly satisfied with internal audit recommendations calling for change in policies and procedures by which their responsibilities are governed and carried out - Table (4.10).

8.3.5 Internal audit reporting characteristics

Characteristics of audit reports fall generally into two categories, those pertaining to substance and those relating to form. From a substance point of view, the empirical research disclosed the following:

1. Addressee: Unless the review is made in accordance with a specific authorisation and instruction of a higher level manager, the internal audit report will be addressed to the manager who has direct responsibilities for the particular functional area that is reviewed - see: Sec. 7.3.1 (a)(i).

Furthermore, as a general internal audit reporting standard in this respect, all audit managers responding agreed that "The internal audit report should be directly submitted to a management official whose organisational position is sufficient to ensure proper consideration and utilisation of the report." - item 1 Table (7.11).

2. The statement of audit objectives and scope: As a general internal audit reporting standard, 79% of audit managers responding agreed that, "An expression

of the specific audit objectives and scope should be contained in the audit report." (item 2 Table (7.11)). The statement of audit objective is particularly clearly stated in non-repetitive type audits. In regular or routine type audits, the audit objective is not often stated in the audit report on the ground that there is no need for repeating the same objectives in each regular or routine audit report - see: Sec. 7.3.1 (a)(ii).

3. The statement of the auditor's opinion: As a general internal audit reporting standard, 96% of audit managers responding agreed that, "The internal audit report should contain a summary of the audit findings and an expression of the auditor's overall opinion concerning the audit area under review." - item 3 Table (7.11), see also Sec. 7.3.1 (a)(iii).

4. Proper consideration for auditees:

- (a) Audit findings are usually communicated to auditees during discussions between auditors and auditees at the end of the audit in 90% of the organisations responding. Other audit departments follow the practice of holding a "closing conference" which often takes place at the end of the field work, just preceding the planned departure of the field audit personnel, and in which main audit findings and proposed recommendations are reviewed with the top members of local management - Table (7.14).

(b) Drafts of audit reports are reviewed with auditees whose functional areas are being audited before the final report goes to a higher level. 95.6% of audit managers responding stated that indications of the corrective action the auditee intends to take are often established and incorporated in the final report as a result of reviewing draft reports with auditees; and 97.8% of them acknowledged that changes in the report's wording and adjustments to audit findings sometimes occur as a result of reviewing draft reports with auditees. Though this audit reporting practice demonstrates a genuine consideration for auditees, however, it implies a possibility that the auditor becomes the captive of the auditee regarding the way in which particular words are used and audit findings are presented, and this may cause an excessive delay in finalising audit reports should they be issued promptly. Yet, the auditee's views about audit points made are often included in the audit reports as a result of this type of internal audit reporting practice - see: Sec. 7.3.1 (a)(iv) esp. Table (7.13).

8.3.6 Internal audit feedback and resolving dual client relationships

One of the most important services of internal auditing is to act as a general source of information which is provided to other company personnel at all levels, and this is especially of significance when the review involves

operations at locations not easily accessible to various company personnel. Here, the internal auditor serves as a supplementary source to bridge the organisational and geographical gaps in the company. The consideration of internal audit as a feedback process brings to a head the conflict that often exists between the responsibilities of the internal auditor to higher managerial levels, and to the management directly responsible for the activity being reviewed. The responsibility in both cases is to provide the protective and constructive services. However, upper level managers have a very practical type of control need. They want to be apprised of significant deficiencies and major operational problems and of important possibilities of carrying out the particular operational activities more effectively. This is in part a need for protection and in part a desire to be helpful. To the managerial levels whose activities are being reviewed there is on the other hand the desire to deal with the internal auditor as a partner and with a kind of private confidential relationship that in no way discredits them with upper managerial levels. The dilemma is that it is this latter type of relationship that best induces co-operation between the auditor and auditee, and this is more likely to achieve meaningful results for local improvement, whereas the former relationship is more likely to be the basis for evaluating the performance and career rewards for the internal auditor.

The problem for the internal auditor is thus how he

can reconcile the two different types of desires and satisfy both parties. For a satisfactory solution, first of all, the responsibilities of internal auditing must be proclaimed clearly and categorically in the organisation's policy. Secondly, internal auditing must have a reporting status in the company that ensures proper consideration of the findings and recommendations developed by the auditor. This will disclose to all company personnel the degree of commitment the organisation has to the nature and scope of the internal auditor's role. The objective of the internal auditor is then to cover the protective needs of higher management levels in a manner which avoids the emphasis in that direction, and instead to stress the constructive potentials through a more determined joint effort between the auditor and auditees to eliminate many of the more minor matters that should be, and can be, finalised at the local level without the irritations that might come from involving higher management levels.

Bearing these explanations in mind, the empirical research disclosed the following findings in this regard:-

- (a) 75% of the organisations responding have issued a policy statement covering the authority, responsibilities, and scope of their audit departments, whereas 25% of the organisations responding stated that they do not have such a document. Thus, most organisations are aware of the way in which the company gives its support to the audit function, and in turn, most audit departments have demonstrated acceptance in

their organisations - See: Table (7.12).

- (b) The organisational placement level of internal audit departments is moving upward - Tables (4.11) and (4.12).
- (c) The empirical research also suggests that real progress has been made as to the current practice of the reporting status of the internal auditor. In 85.4% of the organisations responding, the head of the audit department reports to a senior executive or higher levels many of which (64.6%) are within the finance function, however - Table (4.13) .
- (d) The empirical evidence also revealed a new trend in the reporting status of the audit function which is recognised in the formation of audit committees in some British organisations (most with American connections). In 12.5% of the organisations responding the head of the audit department reports to an audit committee of the board of directors. The membership of these committees often includes the officer to whom the audit manager reports as well as the chief executive, with most firms additionally including 2-3 non-executive directors. Evidently, this will assure maximum independence from functional loyalties and also adequate authority for the audit function which will enable it to extend the scope of its coverage to include all functional areas at any managerial level without being under undue pressure from auditees especially those at higher levels - see: Sec. 4.6.1 esp. Table (4.13).

- (e) Internal auditing provides a regular feedback of information mainly to higher management levels. First, the head of audit department in 85.4% of the organisations responding reports to a senior executive level or higher - Table (4.13). Second, audit reports are regularly communicated to senior executives (i.e. to management above the level of the audit area) in 94% of the organisations responding with a frequency ranging from 75% to 100% of audit reports communicated. Also, periodic summaries of significant audit findings are prepared to these senior executives in two-thirds of the organisations responding with a frequency ranging from 50% to 75% of cases - see: Sec. 7.3.1 esp. Table (7.15).
- (f) As a response to the protective needs of higher management levels, internal audit departments in the organisations responding are extensively involved in an evaluation of existing internal control systems from the standpoint of how well they provide for:-
- (i) protection of resources of the enterprise from losses of all kinds - carried out by all audit departments.
 - (ii) information that is adequate and accurate for management decision-making needs - performed by 96% of audit departments responding.
 - (iii) control of the overall phases of business operations - carried out by 94% of audit departments responding (see: Sec. 7.1.1. esp. Table (7.2)).

(g) The value of internal audit feedback as perceived by executive managers responding is highly acknowledged in so far as the information reported to higher management levels applies to the quality of management systems - Table (6.7). Higher management levels appreciate the audit service in this respect because it extends their knowledge by reporting details and supporting evidence concerning the efficiency of management systems employed - see: Sec. 6.4.2. Internal auditors attempt to keep up dialogue at site level unless matters arise which require action from higher levels (e.g. fraud and dishonesty cases) - see: Sec. 7.3.1 (a)(i).

8.3.7 Obtaining corrective action

The auditor has no responsibility for prescribing the exact path the auditee shall take in correcting or improving conditions. However, the auditee should not be deprived of the auditor's experience and knowledge. Indeed, the auditor does owe some duty to propose *a* method - not necessary *the* method - for improvement. Here the auditor can bring into practice his approach in a problem-solving partnership which will then assure that the action is taken and harmonious relations with auditees are maintained. On the other hand, what action is relevant depends largely on the nature of the particular audit finding. But the critical issue is that the auditor should communicate his findings to whatever level of management he believes will take or ensure

corrective action. Only when the auditor monitors corrective action and has the support of higher managerial levels will his audit efforts bear fruit.

In this context, the empirical research disclosed that:-

- (a) "Recommendations for corrective actions with recommended officials to carry out the action should be included in the audit report, when considered necessary by the internal auditor." This statement has been agreed upon by 79% of audit managers responding, whereas 10.5% of them were uncertain as to its implication, and 10.5% of respondents have dissented it - Table (7.11).

It seems that internal auditors play no specific role after the release of the audit report other than to respond to questions and make sure that recommended corrective actions are acted upon in an appropriate manner - see: Sec. 7.3.1.(c).

- (b) The auditee manager and his supervisor have the primary responsibility for corrective action in more than four-fifths of cases.

Top managers are responsible for corrective action in 4% of cases. Auditees jointly with Methods and Systems Department have this responsibility in 4% of the organisations in which case the internal auditor might be consulted. However, the primary responsibility for corrective action is shared between the audit department and the auditee manager and his superior in 6% of cases. Only 2% of cases

disclosed that the audit department is solely made responsible for corrective actions. It is believed that the move to being responsible for rather than assisting in arriving at the corrective action needed can undermine the basic responsibilities of the auditee manager and his superior, and also may put the internal auditor more in the role of a policeman which conflicts with his ongoing partnership relation with auditees - Table (7.16).

8.3.8 Criteria of good reports

Internal audit reports are the auditor's opportunity to get and command the attention of management at all levels, and to induce them to press for more constructive action. The need for guidelines to produce a persuasive audit report is therefore apparent. However, only 75% of audit managers responding indicated that they evaluate the quality of their audit reports. When asked on what basis they evaluate their reports to get a fair picture of the work done, 10% of audit managers did not respond. The main reason given for this is that "it is too subjective to have standards or measures" to evaluate the quality of audit reports, and as one respondent said "done by feel". Nevertheless, the empirical research has revealed some particular characteristics that are important in producing good reports. They are arranged hereunder in terms of their importance as pointed out by audit managers:-

1. Personal Skill and Communication:
 - (a) professional tone.
 - (b) courtesy and tact.
 - (c) persuasiveness.
 - (d) consideration for auditees.
2. Relevance and Reliability
 - (a) acceptance of, and working to, management policy statement concerning the audit function.
 - (b) comparison with working papers.
 - (c) sample size and tests of errors included.
 - (d) review of audit reports by another person who was not working on related audit assignment.
 - (e) using audit report formats and approach used in similar reports.
3. Standards of Presentation:
 - (a) appropriate language.
 - (b) readability.
 - (c) non-personal phrases.
 - (d) neatness and legibility. (See: Sec. 7.3.1(d)).

8.3.9 Additional constructive audit services

1. Source of Company Managers
 - (a) All audit managers interviewed reported that it is a general practice in their organisations to use the audit departments as a training ground for management and/or supervisory positions; and this type of training service is provided on an overall company basis and not confined to audit staff only. They further indicated that this

audit service may take on the form of inter-changing personnel between the audit department and other departments in the organisation - see: Sec. 7.3.2.

- (b) Using a larger sample, the I.I.A.'s Survey of Internal Auditing in the U.K., 1976 indicated that 48% of the organisations responding stated that they have an in-house training programme for internal auditors and 80% of the respondents reported that audit staff are encouraged to acquire professional qualifications to fit themselves for future line positions⁽³⁾ - Table (7.17).

2. Coordination with the External Auditor

- (a) All audit managers interviewed reported that both internal and external audits are co-ordinated to achieve greater company service. They also indicated that this coordination may be achieved in several ways one of which is through making use of the audit work actually carried out by external audits and/or the restriction of external audit work in areas covered by internal audits. Interviewees further indicated that in some situations they try to maximise the external audit service to their organisations by legitimately exploiting the work of the external

3 Smallbone, M.J., et al (1), op. cit., pp.30-31.

auditor and this is done by keeping themselves informed as to how the external auditors are doing their work especially in areas such as computer audit enquiry packages and statistical sampling - see: Sec. 7.3.3.

(b) Furthermore, all audit departments responding reported that they receive copies of the external audit management letters; and copies of the final, formal reports of internal audits are invariably circulated to the external auditors of their organisations - see: Sec. 7.3.3.

(c) The I.I.A.'s Survey of Internal Auditing in the U.K., 1976 also has come to the conclusion that there exists a consistent pattern of co-ordination and co-operation between the two sets of auditors. 79% of the organisations responding to this survey stated that internal and external audits are co-ordinated to reduce the amount of time spent by the external auditors. Also, 74% of them indicated that copies of internal audit reports are circulated to the external auditors whereas 78% of the respondents reported that they receive copies of the external auditors' reports⁽⁴⁾ - see: Sec. 7.3.3 esp. Table (7.18).

4 Ibid., pp.26-27.

8.4 Conclusions

- (1) *The scope of internal audit is changing to include non-financial aspects of the functional areas under review - Research Hypothesis No.1.1.*

The validity of this hypothesis was clearly demonstrated in the investigation of audit reports and found general support in the responses from both audit managers and auditees in the organisations participating in the study. Considering all the evidence reported, this does not mean that the accounting and financial areas are excluded, but rather that the scope of audit coverage and the type of emphasis has shifted to include more non-accounting and non-financial aspects of the areas under review.

- (2) *The extent to which non-financial areas are audited is related to the line reporting relationship of internal audit - Research Hypothesis No.1.2.*

This hypothesis was composed in line with an assumption widely adopted by the literature as well as the professional bodies of internal auditing but hitherto untested. In this study, the validity of this hypothesis was supported by the results of two different statistical tests which showed significant and positive degrees of association between the reporting status of internal auditing and the degree of its involvement in auditing non-financial aspects of the areas under review, thus suggesting that the

organisational level of the officer to whom the head of the audit department reports is one of the most important factors affecting the type of audit coverage in general and its extension into non-financial areas in particular.

Other factors which were statistically tested and proved to have an impact on the effective functioning of internal auditing in reviewing operational areas are:

- (a) The size of the internal audit department.
- (b) Recruitment of non-accountants for internal auditing.
- (c) The size of the organisation.

(3) *Most internal audit work is concerned with the activities of lower management - Research Hypothesis No. 2.1.*

The empirical evidence did not strongly support this research hypothesis. What was clearly demonstrated is that internal auditors have become able to conduct their review and appraisal at management levels higher than those of lower managerial levels. This is particularly true as to tasks of executive levels - another evidence of extending the scope of internal audit into operational areas. It would appear, however, that internal auditors are not yet able to conduct effective reviews at administrative levels, though most of them are attempting to cope with reviewing tasks of these higher management levels.

One significant factor affecting the internal auditor's ability to conduct effective audits at administrative levels is his reporting status. Objectivity may be difficult to achieve in making an appraisal when the auditor's economic and job security are controlled by those directly affected by his appraisal. The auditor may be hesitant in criticising the activities of administrative levels and would be likely to view the work under audit in a prejudicial manner favourable to the particular individual involved. Perhaps, when the internal auditor is made responsible to an audit committee, which among other things will act as a quasi-judicial body in matters relating to the appearance of the auditor's independence in respect to any audits he may conduct, he will enjoy a higher reporting status which in turn will enable him to conduct his reviews at any level without being under undue pressure from his auditee to the extent that might bias his opinion.

The empirical evidence also suggests that the size of the internal audit department and the character of its personnel in addition to the size of the organisation - all have an impact on determining whether internal auditors conduct their audits at various management levels.

- (4) *Internal audit attempts to confine its appraisal activity to auditing the quality of management*

systems rather than to auditing the quality of management individuals themselves as (i) this is the nature of the accepted audit task, and (ii) this helps to avoid alienating internal audit from other management - Research Hypothesis No.2.2.

This hypothesis found general support in the responses from both audit managers and auditees, and its validity was well demonstrated in the results of the investigation of audit reports.

Regardless of the wide acceptance of this hypothesis, confining the internal audit appraisal activity to a review of controls which excludes an evaluation of individuals' performance might arguably reduce the value of the total internal audit service since the auditor is not looking at all aspects of management performance of which the quality of personnel performance is very important factor. While the review and appraisal of personnel performance would result in a greater service to the company, the question remains as to whether the gains from the added service would exceed the costs of attaining it when it was performed by the internal auditor. The probability of management resentment against the auditor and his critical recommendations is one important consideration. An uncooperative attitude on the part of auditees - that would tend to spread through the company and influence all its members - is another. These considerations could be the

reason why most internal auditors are reluctant to evaluate the quality of management itself, though they would otherwise like to.

If the very nature of the internal audit role makes it an excusable practice for the auditor to exempt individual performance from the scope of his appraisal activity, the review of technical performance should not be seen in the same light on the ground that the auditor may not possess special experience and knowledge about the technical aspects of the particular operational area to be reviewed. His competence in the control function gives the internal auditor a credential for entry into the different operational areas including their technical aspects, and the basis for making a constructive contribution to the managers responsible for those operational areas. Special knowledge about the technical aspects of operational areas is not an overriding prerequisite.

In this context, the important point is that an increasingly wide range of skills is needed for internal audit to fulfil its role within a broader scope and, therefore, the recruitment effort of internal auditors should focus upon those needed skills in various fields but this must be complemented by a proportion of experienced internal auditors. Important also is the need to provide continuing education to cover new developments with which practicing internal auditors should be familiar.

- (5) *Most of internal audit's recommendations for systems changes which are designed to improve internal control are made by an analysis of historical happenings. While the recommendations for systems changes are designed to influence the future functioning of management systems, internal audit rarely appraises the forward planning systems of the organisation and thus misses a major opportunity to influence future events. Occasionally internal audit makes a post-project review of forward planning by comparing actual with budget (i.e. an audit of corporate planning by an appraisal of historical happenings) but it is almost unknown for internal audit to appraise corporate plans relating to a future which has not occurred - Research Hypothesis No.3.1.*

This hypothesis found general support and was confirmed in the responses from both audit managers and auditees. Its validity was also clearly demonstrated in the investigation of audit reports. Freedom from executive functions, of which systems design is a part, in order to avoid the destruction of objectivity by the creation of vested interests is one of the basic principles upon which internal auditing should be founded. It would appear, however, that this philosophy has recently been modified in some situations. Internal auditing is increasingly involved in participation in the development of new

systems (e.g. computer systems) but its role in this regard is still restricted to making recommendations with regard to internal control features which should be incorporated in the proposed systems. There is also emerging in a number of organisations the view that the internal audit department can provide better company service by participating more actively in the development of both the organisation's plan and its major policy decisions. The rationale is that the internal auditor has the experience and overall view of the organisation's activities which makes his counsel at the decision-making stage very valuable. This might indicate a new departure from the audit of historical happenings to the audit of management decisions as well, which eventually might require different qualifications and skills on the part of internal auditing in the organisation.

Admittedly, however, the possible threat to objectivity is still there and the internal auditor must handle himself in such a manner that his later independence and objectivity in subsequent audits are not undermined. Nevertheless, it is believed that there are significant potential benefits to be achieved and the researcher lists this point as one of the continuing problems that deserves internal auditors' consideration. It could well be that the internal auditing profession has now matured to the point where it could provide the new type

of company service, and still go on rendering the now existing range of services to management and other interested parties, probably on an even more constructive basis.

(6) *Internal auditors are generally successful in making audit recommendations which :*

(i) emphasise the basic protective aspects of the operations reviewed as well as the improvement of these operations.

(ii) help auditees to recognise their own problems and inefficiencies. Research Hypothesis No.3.2.

This hypothesis also found general support and was confirmed by both audit managers and auditees; its validity was demonstrated in the investigation of audit reports and other audit documents. Considering all the evidence reported, it would appear that the old image of the internal auditor as being a financially oriented checker and more of a policeman than co-worker, no longer applies to such an extent. However, this does not deny the fact that the present state of auditor-auditee relationships still encounters roadblocks in some situations. This could be explained as a direct result of internal audit role conflict and the approach used by the internal auditor in resolving his dual client relationships previously referred to (see: Sec. 8.3.6). It would seem, however, that the degree of conflict varies according to the needs and attitudes of the auditee managers at various management levels.

On the other hand, internal auditors proved able to satisfy the basic protective needs of the firm, and as a result of this, upgraded in the minds of higher level managers. Top level managers, however, do not view themselves as auditees despite being subjected to internal audits in a few cases and consider their subordinates to be the actual auditees; meantime, they perceive internal auditors as their agents with the task of using their "eyes and ears" as a partner of management at these top levels. Accordingly, higher level managers appreciate the internal audit service because it satisfies their protective needs and at the same time sharpens their judgement as to the performance of the lower levels. Bearing in mind that it is these higher level managers who pass final judgement upon the worth of the services of the internal auditor, and who influence and ultimately determine his compensation, organisational status, and overall progress in the organisation, it is no surprise then that many internal auditors have resolved the problem more in the direction of providing a service to higher level managers. Executive managers, on the other hand, seem to be somewhat neutral in their reactions toward internal auditors. They view themselves as auditees but with broad responsibilities for major actions affecting the company's success and enjoy organisational status and the right of access to higher level managers equal to those given to internal auditors in many

cases. Therefore, they view internal auditors as their colleagues and ideally would like to work with them on a friendly professional basis. The key point here is the auditor's attitude. Normally, a coercive or over-bearing attitude would not contribute to success but a willingness to provide advice and support to operating personnel in solving problems and managing their own areas of responsibility increases the auditor's probability of being able to constructively influence executive managers' behaviour and attitudes.

Lower managerial levels need internal auditors' help and advice but they want them on a private basis that in no way discredits them with their superiors. Yet, they view internal auditors as having more influence than that perceived by executive managers and therefore they are more aware of the internal auditor's inspectorial or policing role and therefore they are usually deeply suspicious of internal auditors' motives. Once again, the key point is the auditor's attitude. The internal auditor must be able to get along with, and gain the respect and confidence, of, management - especially those at lower levels - while making a judgement about their activities.

In fairness to the current practice of internal auditing, it must be said that the trend is in the direction of adjusting the traditional image, and

most internal auditors do attempt to balance their approach in resolving their dual client relationships.

8.5 Suggestions for Further Research

The concept followed in developing the new internal audit Standards is that internal auditing is, more than ever before, becoming, and will continue to become, more ACCOUNTABLE to the organisation as a whole - such as to audit committees of the board of directors and even to society rather than exclusively to management. Management is not the entire organisation, nor the only party interested in the work of the internal auditor.

Accountability is one of the basic premises on which organisations are founded. It simply means that responsibility received carries a duty to report on responsibility discharged. The desirability of extending the internal auditors' accountability carries two key implications.

On the one hand, internal auditors would have to make the results of their audits available to those to whom the audited officials are accountable. From this standpoint, internal auditors perform two services for those to whom accountability is due. First, they evaluate the propriety of financial and operating reports that are intended to discharge accountability. Second, they evaluate the operations and controls of the organisation against predetermined standards to disclose the degree of efficiency and effectiveness with which the organisation is operating.

All findings and conclusions reported in this study are mainly concerned with the extent to which these two services are provided by internal auditors in the organisations participating in the study.

On the other hand, accountability is not completely achieved unless some testing of reporting DEPENDABILITY is made available. Reporting dependability means that those to whom internal audit accountability is due, in order to have a rational basis for their future decisions concerning the approval of a budget for the internal audit department, must possess facts concerning the performance of the internal auditors themselves. Does the company get the maximum possible value from the funds that are actually being expended on internal auditing? This highlights the need for evaluating the value of internal auditing services. The test of internal audit's effectiveness, the literature would suggest, in all cases has been expressed in terms of the extent to which benefits are gained. The question that has not yet been clearly answered is how does one actually evaluate and measure the benefits of various internal audit services provided?

Admittedly, the problems of measuring performance in service areas are difficult. However, internal auditing services deserve support only to the extent that they represent a profitable investment in the company.

The efforts to find satisfactory measures for the evaluation of the benefit of internal audit services are

essentially a response to the fact of the necessity for the evaluation which in some way must be made. And this makes the case for more intensive research in this regard all the more important.

The extension of internal audit accountability also means that there can be legitimate needs for the internal auditor's services not only by the responsible management at any level but also by the owners, workers, and society.

A question that poses itself is what is the nature and scope of the now existing new internal audit services?

Accountability, for instance, would be facilitated if an independent appraisal could be periodically indicated to the owners and other interested parties how well management is "managing" provided that adequate standards to measure its overall performance are employed. Notwithstanding the difficulty inherent in the measuring process itself, it seems that the tedious though unsatisfactorily answered question of whether internal audit appraisal means an audit FOR or OF management would pose itself once again.

If internal audit appraisal is interpreted as an audit FOR management, which is widely accepted, this will add another complexity to the already existing conflict between the responsibilities of the internal auditor to top management and local management; and the desirability of extending the internal auditor's accountability would seem then incompatible with his role as being of service to management.

On the other hand, if internal audit appraisal is considered to be an audit OF management the auditor's competence and independence would be seriously questioned under their present state.

And here again, the desirability of extending the internal auditor's accountability to other interested parties in the company, or even outside it, would seem incompatible with his service to management of which top echelons are among those to whom his accountability is due, after all.

Perhaps the concept of the auditor's independence is the crucial element in this last point. Understandably, independence is not susceptible of precise definition. It is, however, an expression of the professional integrity of the auditor and implies freedom from personal attachment, from mutuality of interest, and from control by others.

The appraisal function relies upon independence, but the auditor's position is tied to, or dependent upon, the attitudes of those being appraised (i.e. management). While the auditor is hesitant to be critical and may be somewhat biased in reporting to management, the issue would be clouded even further if he were made more accountable to others because an auditor must be effective or risk losing his job. The internal auditor would have a conflict between the necessity of performing his job (the audit OF management) and the anxieties attached to its performance (to be more accountable to others).

Should internal audit be independent OF management in order to become effectively more accountable to others? - another question that needs to be adequately investigated.

The continuing vitality of any profession lies to a major extent in its ability to serve society in a broader sense, and to evolve with the times.

There is enough evidence of the value of the internal audit function to justify considering the extension of its services to other parties interested in the organisation and not only to the management responsible for its managing. For instance the internal audit department of the London Stock Exchange provides a service to its member firms who are its proprietors. There are already cases on record, for instance, of an internal auditor's 'Opinion' being printed in the annual report of corporations, addressed to the proprietorial and other interested parties. The S.E.C. in the U.S. has decreed that large corporations must have internal audit in order to discharge their responsibilities to society under Foreign Corrupt Practices Act (1978) and internal audit is also mandatory in the U.K. public sector. The Nordic Congress of Internal Auditors in 1977 spent much of its time discussing means of providing internal audit reassurance to company workers that information provided to their representatives by management, as prescribed by law, was dependable.

This broader view, however, does not deny the fact that the internal auditor has certain basic responsibilities

to management in the conduct of a business and further study is therefore needed into the compatibility of rendering a service to the organisation and society as a whole with providing a service to management. The problem revolves around the nature and scope of services and, necessarily, the concepts of accountability, competence, and independence are the focal points of this problem. It is quite possible that more intensive research would provide better insights into many of the questions raised.

Appendix (A)
Research Correspondence



The City University Business School

LIONEL DENNY HOUSE, 23 GOSWELL ROAD, LONDON EC1M 7BB 01-253 4399

February 1976

Dear Member

Recently internal audit managers have been bothered by several questionnaires from researchers who have been most grateful for the response. It is with trepidation that I now add one other request.

So as not to bother you further if you feel you cannot get involved this time, I am asking you to despatch the slip at the bottom of this sheet ONLY if we may send you the relevant material.

As you will realise, much research in the social sciences (of which internal audit is a branch!) is questionnaire based. I have several research students studying for Ph.D.'s in internal auditing and we are doing all we can to devise research methods which do not involve questionnaires as we realise there is a limit to the number of questionnaires which are acceptable. But there is a residue of research which has to be questionnaire-based,

To: Mr Raafat Ali Radwan, B.Com., M.A. (Accounting),
The Graduate Business Centre, The City University
Lionel Denny House, 23 Goswell Road, London EC1M 7BB

From: (name and address):
.....

- I would be willing to attempt to complete an 'Internal Audit Manager's Questionnaire'
- I would be willing to try to arrange to have completed an 'Executive Managers' Questionnaire'
- I would be willing to pursue further the possibility of allowing you to see in confidence copies of audit reports, programmes, and correspondence.

(TICK AS APPROPRIATE)

and at The City University we do count on the cooperation where possible of the internal audit profession to facilitate internal audit research which is of course intended to be beneficial to the internal audit world.

In this case Raafat Radwan is researching into the management levels and the management functions at which internal audit both attempts to, and succeeds in, providing a service - and the nature of that service at each level and function. Only a small part of his research involves confidential questionnaires: the rest will require him to conduct a confidential review of audit programmes, audit reports and audit correspondence of a small number of organisations. We are principally concerned to invite you to participate in the questionnaire, but on the slip at the end of page one we provide a space for you to indicate whether, at a future date, you might be prepared to allow Mr Radwan to study some of your audit reports etc. I should emphasise that your assistance with the questionnaires would be most valuable even if you cannot later provide access to audit reports.

The questionnaire should take you about 40 minutes to complete. In addition we would appreciate it if you could arrange for another questionnaire to be completed by an executive manager outside the audit department who has experienced an internal audit as auditee: this would take him about 20 minutes.

We do understand if you feel you cannot assist but would much appreciate any help you can give. You would of course have an opportunity to receive the research results in due course.

Yours sincerely

Andrew D Chambers

Leverhulme Senior Research Fellow in Internal Auditing



The City University Business School

LIONEL DENNY HOUSE, 23 GOSWELL ROAD, LONDON EC1M 7BB 01-253 4399

May 1976

Dear Mr.

In February I asked if, yet again, you would be willing to participate in a research project which is partially questionnaire based. I enclose a copy of the letter you should then have received from me.

Understandably few consented - probably in view of the flood of questionnaires at that time. Of 700 letters sent only 32 returned the tear-off slips.

I am concerned about this as my research student's project and his Ph.D. are in jeopardy.

In the circumstances I trust you will not be too cross about this follow-up letter which again seeks to solicit your assistance on this project. It would be of real value even if you could arrange for only one of the two questionnaires to be completed.

If you are now in a position to assist, please would you return the tear-off slip from the enclosed letter to Mr Radwan.

Thank you very much for your patience.

With very best wishes.

Yours sincerely

Raafat Radwan

pp Andrew D Chambers

Leverhulme Senior Research Fellow in

Internal Auditing



The City University Business School

LIONEL DENNY HOUSE, 23 GOSWELL ROAD, LONDON EC1M 7BB 01-253 4399

ADC/j1

May 1976

Recently many internal auditors have been bothered by several questionnaires from researchers who have been most grateful for the response. It is with trepidation that I now add one other request. So as not to bother you further if you feel you cannot get involved this time, I am asking you to despatch the slip at the bottom of this sheet only if we may send you the relevant material.

As you will realise, much research in the social sciences (of which internal audit is a branch?!) is questionnaire-based. I have several research students studying for Ph.D.'s in internal auditing and we are doing all we can to devise research methods which do not involve questionnaires as we realise there is a limit to the number of questionnaires which are acceptable. But there is a residue of research which has to be questionnaire-based,

To: Mr Raafat Radwan, B.Com.,M.A.(Accounting),
The Graduate Business Centre, The City University,
Lionel Denny House, 23 Goswell Road, London EC1M 7BB

From: (name and address):
.....

I would be willing to attempt to complete an 'Internal Audit Manager's Questionnaire'.

I would be willing to try to arrange to have completed an 'Executive Managers' Questionnaire'.

(TICK AS APPROPRIATE)

and at The City University we do count on the cooperation where possible of the internal audit profession to facilitate internal audit research which is of course intended to be beneficial to the internal audit world.

In this case Raafat Radwan is researching into the management levels and the management functions at which internal audit both attempts to, and succeeds in, providing a service - and the nature of that service to each level and function. Only a small part of his research involves confidential questionnaires: the rest will require him to conduct a confidential review of audit programmes, audit reports and audit correspondence of a small number of organisations. We invite you to participate in the questionnaires.

The questionnaire should take you about 20 to 30 minutes to complete. In addition we would appreciate it if you could arrange for another questionnaire to be completed by an executive manager outside the audit department who has experienced an internal audit as an auditee: this would take him about 20 minutes.

If you are not an internal audit manager, could I trouble you to pass this letter to whoever does that job in your organisation.

We do understand if you feel you cannot assist but would much appreciate any help you can give. You would of course have an opportunity to receive the research results in due course.

Yours sincerely

Andrew D Chambers

Leverhulme Senior Research Fellow in

Internal Auditing



The City University Business School

LIONEL DENNY HOUSE, 23 GOSWELL ROAD, LONDON EC1M 7BB

01-253 4399

Just a note of sincere thanks for your willingness to help Raafat Radwan with his research project. With this note come the relevant questionnaire or questionnaires. Raafat will be liaising with you should any matter need resolution.

Yours sincerely

Andrew D Chambers

The Leverhulme Senior Research Fellow in
Internal Auditing



The City University Business School

LIONEL DENNY HOUSE, 23 GOSWELL ROAD, LONDON EC1M 7BB 01-253 4399

May 1976

Thank you for your co-operation in completing the Questionnaire that I sent you, which I am sure will be of great help in my research programme.

In that Questionnaire you kindly expressed willingness for me to see - in confidence - copies of audit reports, programmes and correspondence.

I would therefore be very grateful if you would suggest a date and time when this material would be available for me to study. In the first instance it would probably be appropriate for me to spend the better part of a day at your organisation, and then perhaps I could discuss with you the best way to proceed with the material thereafter.

Thanking you in anticipation.

Yours sincerely

Raafat A Radwan

Appendix (B)

Internal Audit Managers' Questionnaire



THE CITY UNIVERSITY

GRADUATE BUSINESS CENTRE

Internal Audit Managers' Questionnaire

Confidential

All information you give will be used only for research purposes and it will be kept strictly confidential. People and Organisations will not be identifiable in the final results of this study. While it would be helpful if you answered all questions, your reply will be useful even if you decide to 'pass' on certain questions.

Please return to: Raafat Radwan (PhD student) at
The Graduate Business Centre
The City University
Lionel Denny House
23 Goswell Road
London EC1M 7BB

1. May I please have your name and address?

Name:
Address:
.....
Postcode:
Telephone No.:

2. Would you mind giving me a few details about your Organisation, as follows:

- Organisation's name:
.....
- The main activity:
.....
- Total number of employees:
- Issued share capital (if appropriate):

3. Your job title and a short description of your principal responsibility(ies):

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4. How many people are employed as internal auditors in your Organisation?

Accountants as auditors:
Non-accountants as auditors:
Clerical and secretarial:
Others, (please specify):
.....
.....

5. Is there a management policy statement covering the authority, responsibilities and scope of the internal audit department within your Organisation?

YES NO TICK ONE BOX ONLY

5(a) If 'YES', would you please provide me with a copy of the management policy statement of the internal auditing function in your Organisation (please mail to me with this completed questionnaire)?

YES NO → see 5(b)

5(b) Please provide a brief outline of its contents:

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6(a) Before carrying them out, are your long-range programmes (or schedules of audit work) reviewed with higher management in your Organisation?

YES NO

6(b) If 'NO', do your long-range programmes (or schedules of audit work) set out in detail each audit step to be performed?

YES NO

7. Do your detailed audit programmes for each audit:

(a) focus attention on the maintenance of accurate management control systems which will by themselves prevent or disclose weaknesses?

YES NO

(b) confine themselves to general statements of relevant auditing theory and practices?

YES NO

Comments:

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8. Please mark with a tick to indicate the frequency with which any of the following management levels are within the scope of your internal audits?

Always	Mostly	Often	Some times	Seldom	Never
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Comments

(i) Administrative and Upper Executive Levels
 (e.g. the chairman of the board of directors, the company president and executive vice-president).

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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(ii) Executive levels (e.g. other vice-presidents, major division or department or branch heads, and plant managers).

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(iii) Lower Managerial Levels
 (e.g. first-line or second-line supervisors and foremen).

<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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9(a) As an internal audit manager, do you think that appraising the quality of performance in carrying out assigned responsibilities should have a place within the internal audit activities?

See 9(b) ← YES

NO → Pass to Q.10

9(b) Would you please indicate to what extent each of the following management levels should be subjected to an appraisal of the quality of their performance in carrying out their assigned responsibilities?

(Note: Management levels are viewed as in Question 8).

Always	Mostly	Often	Some- times	Seldom	Never
--------	--------	-------	----------------	--------	-------

(i) Administrative and Upper Executive Levels

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(ii) Executive Levels

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(iii) Lower Managerial Level

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10. Which of the following activities are done by the internal audit department of your Organisation?

	YES		
NO	Extensive	Moderate	Little

(i) Review and appraisal of existing management control systems

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(ii) Development and installation of new systems and procedures

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(iii) Review of newly developed or revised systems and procedures prior to their adoption

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	YES		
NO	Extensive	Moderate	Little

(iv) Review and appraisal of the organisational aspects of the enterprise in so far as these have a bearing on good administrative performance and control

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(v) Evaluation of overall performance of various operating departments from the standpoint of:-

(a) plan of organisation

(b) policies in effect

(c) procedures being followed

(d) results

(e) individual performance

(vi) Evaluation of internal control systems from the standpoint of how well they provide for:

(a) information that is adequate and accurate to management decision-making needs.

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(b) protection of resources of the enterprise enterprise from losses due to theft, embezzlement or carelessness.

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(c) control of the overall phases of business operations.

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Comments:

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11. Please indicate your view concerning the following statements by ticking one box on each line:

Agree	Uncertain	Disagree
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- (i) Most internal audit work is concerned with the accounting and financial aspects of the lower managerial (i.e. supervisory) levels (as defined in Question 8).
- (ii) The scope of internal audit work has extended into non-accounting and non-financial aspects of executive levels (as defined in Question 8)
- (iii) Internal audit attempts to cope with reviewing tasks of administrative levels (as defined in Question 8).

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12(a) Is the internal auditor required to appraise corporate plans relating to a future which has not yet occurred?

See 12(b) ← YES NO → Pass to 12(c)

12(b) If 'YES', on what topics did your internal audit department issue reports relating to the future of your organisation during the last three years?

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12(c) If 'NO', what other methods or means, if any, have been developed to cover this ground (i.e. an independent review of future plans) (Please give a short description)?

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13. Please mark with a cross to indicate the frequency with which the following audit modes or styles are followed in the work of the internal audit department within your Organisation.

NO	YES		
	Extensive	Moderate	Little

- (i) Functional Mode (a functional audit is confined to one subject or process, it cuts across organisational lines and literally follows the function wherever it is performed throughout the organisation. Functional audits tend to concentrate more on operations and processes than on administration or people).

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- (ii) Departmental Mode (a departmental audit selects for review all activities in the control of a given managerial position and may therefore involve a review of several unlike subjects. Departmental audits tend to concentrate more on administrative controls and people, than on processes flowing through the organisation).

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- (iii) Management Studies (when a top-notch internal audit team participates in special studies involving making an evaluation of, and offering recommendations for improvements in, problem areas of the business).

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14. In your own words, please specify the audit modes which indicate the direction or scope of audit work undertaken in your Organisation? (Please provide a brief description of each).

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15. The main purpose of internal audit points made to management (Please tick one box on each line):

Agree	Uncertain	Disagree
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(i) merely to identify the problems within the audited areas, i.e. pointing out weaknesses.

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(ii) identifying the problems and making recommended solutions.

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(iii) emphasising organisational weaknesses and making recommendations for organisational improvements with less emphasis on procedural weaknesses and procedural recommendations.

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16(a) To whom does the audit manager report organisationally?

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16(b) Please give a brief description to clarify the general circulation of internal audit reports in your organisation.

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17(a) Are drafts of internal audit reports reviewed with auditees before the final report goes to higher level?

See 17(b) ← YES NO → Pass to Q.18

17(b) If 'YES', how does this affect the reported findings and recommendations:

Always	Mostly	Often	Some- times	Seldom	Never
--------	--------	-------	----------------	--------	-------

(i) Changes in the report's wording

--	--	--	--	--	--

(ii) Adjustments to findings

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(iii) Indication of the corrective action the auditee intends to take

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Comments:

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18(a) As an internal audit manager do you constructively question the quality of your internal audit reports to make sure they present a fair picture of the work of your department.

YES

NO

18(b) If 'YES' what standards or measures of quality have been developed to get such a fair picture?

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19(a) Are internal audit reports regularly communicated to senior executives (i.e. to management above the level of the audit area)?

YES



How often (%).....

NO

19(b) Are periodic summaries of significant findings prepared for these executives?

YES



How often (%).....

NO

20. Are reports calling for systems changes discussed with:

(i) senior executives?

YES

NO

(ii) the procedures people or systems analysts?

YES

NO

(iii) anyone having responsibility for the area or condition needing change?

YES

NO

21. Give examples of major changes which have occurred in management's systems as a result of internal auditors' recommendations during the last three years.

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22. After the release of the audit report, who has the primary responsibility for corrective action:

(a) Internal audit department?

YES

NO

(b) The auditee manager and his superior?

YES

NO

(c) Internal audit department jointly with the auditee and his superior?

YES

NO

(d) Other, please specify:

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.....

23. Please indicate your opinion concerning the following proposed general internal audit reporting standards by ticking one box on each of the following lines:

Agree	Uncertain	Disagree
-------	-----------	----------

(i) The internal audit report should be directly submitted to a management official whose organisational position is sufficient to ensure proper consideration and utilisation of the report.

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(ii) An expression of the specific audit objectives and scope should be contained in the internal audit report.

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(iii) The internal audit report should contain a summary of the audit findings and an expression of the auditor's overall opinion concerning the audit area under review.

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(iv) Recommendations for corrective actions with recommended officials to carry out the action should be included, when considered necessary by the internal auditor.

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24. Does your internal audit department render any sort of assistance to carry out the following investigations....

Always	Mostly	Often	Some-times	Seldom	Never
--------	--------	-------	------------	--------	-------

- (i) The soundness of the build-up of standards at the time they were formulated where standard costs are in use (e.g. sales forecasts in relation to factory capacity, whether expense budgets have regard to past performance and are conditioned to anticipated future conditions, etc, etc)?
- (ii) The decision to manufacture products with the laying down of the necessary plans?
- (iii) The decision to undertake capital expenditure projects?
- (iv) The control exercised over authorised capital expenditure?
- (v) The establishment of revenue expenditure budgets for the organisation?
- (vi) The verification of accounting returns recording historical data and their relation to budgets, before they are submitted to management?

25. If required, would you please be prepared to let me see (on a strictly confidential basis):

(i) Internal audit reports for the past five years?

YES

NO

If 'YES', how many (approximately)

(ii) Internal audit's annual plans of audits to be done

YES

NO

(iii) Audit's programmes of work to be done in each audit

YES

NO

If 'YES', how many (approximately)

(iv) A sample of correspondence between auditors and auditees before and after audits.

YES

NO

(v) Statement covering rights of access and reporting structure of internal audit.

YES

NO

26. Please add any further comments you may wish about your internal audit function and this questionnaire?

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27. Please let me know if you wish to be informed further of the results of this study.

YES

NO

With my grateful thanks for your co-operation.

Appendix (C)

Questionnaire for Executive Managers



THE CITY UNIVERSITY

GRADUATE BUSINESS CENTRE

Questionnaire for Executive Managers

Confidential

All information you give will be used only for research purposes and it will be kept strictly confidential. People and Organisations will not be identifiable in the final results of this study. While it would be helpful if you answered all questions, your reply will be useful even if you decide to 'pass' on certain questions.

Please return to: Raafat Radwan (PhD student) at
The Graduate Business Centre
The City University
Lionel Denny House
23 Goswell Road
London EC1M 7BB

1. What is your job title (please give a brief description of it)?

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2. What is the job title of the officer to whom you report?

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3(a) When was your last contact with the internal audit department in your Organisation?

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3(b) Please indicate the extent of your usual contact with the internal audit department in your Organisation

Little

Moderate

Extensive

3(c) Please describe briefly which part(s) of your responsibilities have been subjected to internal audits during the last two years:

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4(a) Please tick to what extent internal audits result in change in:

Always	Mostly	Often	Some- times	Seldom	Never
--------	--------	-------	----------------	--------	-------

(i) Policies by which your responsibilities are governed?

--	--	--	--	--	--

(ii) Management's systems by which policies are carried out?

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4(b) Please give examples of major changes which have occurred (in any of 4(a) above) as a result of internal audit's recommendations relating to your responsibilities:

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4(c) To what extent are you satisfied with the internal auditor's recommendations calling for changes (in any of 4(a) above) relating to your responsibilities

Satisfied Partly satisfied Dissatisfied

5. How do you obtain information of internal audit findings and recommendations?

Always	Mostly	Often	Some-times	Seldom	Never
--------	--------	-------	------------	--------	-------

(i) from discussions with internal auditors during their audit.

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(ii) from discussions with internal auditors at the end of their audit

--	--	--	--	--	--

(iii) from internal audit report drafts

--	--	--	--	--	--

(iv) from the final audit report

--	--	--	--	--	--

(v) from my superiors after the audit

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Comments:

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6. Please indicate your opinion concerning the following statements by ticking one box on each line.

Agree	Uncertain	Disagree
-------	-----------	----------

(i) The bulk of audit reports related to weaknesses observed by the auditor (i.e. criticisms) with less emphasis on the strengths observed in management's systems (i.e. praise), with a consequence that auditees consider the auditor to be unfair and unwelcome.

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Agree	Uncertain	Disagree
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- (ii) Most internal audit recommendations calling for changes in management's systems cause unnecessary changes in the area under review.
- (iii) Internal audit reports provide a feedback of information to higher management levels as to the quality of management's systems
- (iv) Auditors are generally unsuccessful in making audit points which related directly to the original objectives of the audit
- (v) Auditors are generally unsuccessful in making audit points which help auditees to recognise their own problems and inefficiencies.

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7(a) Is there a management system employed in your Organisation to evaluate the quality of your performance in carrying out assigned responsibilities?

YES

NO → Pass to question (c)

7(b) If 'YES' does the internal audit department of your Organisation have the responsibility to carry out the evaluation process?

Complete responsibility

Partial responsibility

No responsibility

7(c) How do you evaluate your people's performance (please give examples of main standards which have been developed to cover this ground)?

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7(d) Is there any type of assistance received from the internal audit department of your Organisation to assist the evaluation in (c) above?

Extensive	<input type="checkbox"/>
Moderate	<input type="checkbox"/>
Little	<input type="checkbox"/>
Nothing	<input type="checkbox"/>

8. Please add any further comments you may wish about the internal audit function (e.g. to what extent has it been of value to you in your work, how do you think it should be altered, what are your criticisms and suggestions, etc.).

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9. Please let me know if you wish to be informed of the results of this study.

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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With my grateful thanks for your co-operation.

Appendix (D)
Audit Managers' Interview Schedule
and
Questionnaire for the Investigation of
Internal Audit Reports

Audit Managers' Interview Schedule

1. Introduction

Thank you for your co-operation in completing the Questionnaire that I sent you, which I am sure will be of great help in my reserach programme.

In that questionnaire you kindly expressed willingness for me to see copies of your audit reports and other audit material. The following is a list of the material required, and all information will be treated entirely confidentially, of course.

- Internal audit reports.
- Audit programmes of work to be done in each audit.
- A sample of correspondence between auditors and auditees before and after the audits.
- Rights of access and reporting structure of internal audit.
- A copy of the management policy statement of the audit function (if not mailed with the Questionnaire).
- A copy of the organisation chart.

2. Then, a brief discussion concerning the questionnaire used in investigating the above audit material is brought up.

Details of matters raised in this questionnaire are given in a supplement to this schedule (see: "Secondly" in this appendix).

3. After completing the investigation of audit reports and other audit material, the audit manager in charge is interviewed. The purpose of the interview is to elaborate on some particular points mentioned in the mailed questionnaire, also to add a

few new questions which arose during the investigation of audit reports.

4. Interviewees were encouraged to express whatever opinions they cared to make about their views of the audit function in their organisations. Through this approach many issues were raised and discussed, among which are the following:-

- (a) Should internal auditors be involved in appraising management performance? This question is debatable. It was desirable, therefore, to discuss this issue with audit managers. The problem is generally defined and introduced to interviewees as follows:
- 'The accounting and financial control areas were the original concern of the internal auditor and continue to be of major interest and importance. Currently, internal auditors are attempting to extend the scope of their appraisal activity to other types of operations seeking for more efficiency and greater profitability in the broadest sense. This upward thrust in all operational areas to embrace larger issues means audit involvement at higher and higher managerial levels. Here the road becomes increasingly difficult and the question is often raised as to what extent the internal auditor is able to go in terms of the scope of his review to contribute constructively to the managers who are responsible for managing the business'.

The following questions were then asked:-

Q.1 (i) If particular management levels are subject to internal audit in your organisation (expansion of Q.8, Q.9, and Q.11 in Internal Audit Managers' Questionnaire (see Appendix (B)):

(a) = what aspects of their activities have priority in your audit programme

- + financial aspects? AL EL LML
- + non-financial aspects?

(b) = what aspects of their performance are usually covered:

- + management controls? AL EL LML
- + management decisions?
- + individual performance?
- + technical aspects?

(ii) Are there more difficulties in the audit of these aspects, compared to the accounting/ financial aspects of each level? YES NO

= If 'YES', why? Please provide some reasons if possible.

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Q.2 A discussion about the particular characteristics that are important in producing audit reports was developed, then the following questions were asked (expansion of Q.23 in Internal Audit Managers' Questionnaire (see Appendix (B)):

(i) To whom should the written audit report be addressed YES NO

- = the auditee manager?
- = the manager to whom the auditee is responsible?
- = the auditee manager and his superior?
- = other, please specify?

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(ii) In your opinion,

(a) = should the auditee's views about audit points made be included in the audit report?

(b) = should satisfactory conditions or favourable findings be included in the audit report?

Comments:

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Q.3 A discussion concerning the internal audit effort in training and developing people and making them available for other company needs, then the following question was asked:

= Is there a general policy or practice within your organisation to: YES NO

+ interchange personnel between the audit department and other departments?

+ use the internal audit department as a training ground for management or supervisory positions?

+ limit the term of duty for internal auditing staff?

Comments:

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Q.4 A discussion about the internal audit relationship with the external auditor, then the following

questions were asked: YES NO

(i) Are Internal and External Audits

co-ordinated to:

+ encourage less external auditing

in areas covered by Internal

Audit?

+ restrict internal auditing in

areas covered by External Audit?

(ii) Are copies of Internal Audit

Reports circulated to the

External Auditor?

(iii) Does the Internal Auditor

receive copies of the External

Auditor's Reports?

((ii) & (iii) above are expansion of

Q.16(b) in Internal Audit Managers'

Questionnaire (see Appendix (B)).

Comments:

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• THANK YOU FOR YOUR CO-OPERATION. You would of course have an opportunity to receive the research results in due course.

Secondly: Questionnaire for the Investigation of Audit Reports

Section (1): Scope and reporting characteristics of the internal
audit departments concerned

Questionnaire	Yes	No	Remarks
<p>(1) Is there an expression of the specific audit objectives and scope contained in the report?</p> <p>(a) if "Yes", consider the following:</p> <p>i - is the audit identified as:</p> <p>** a regular examination?</p> <p>** a response to a special management request (if so, for what purpose and on what topic)?</p> <p>ii - does the scope statement disclose the audit steps</p> <p>** in detail?</p> <p>** in general?</p> <p>iii - does the scope statement indicate any particular auditing technique being followed?</p> <p>iv - what is the nature of audit work carried out</p> <p>** internal check work?</p> <p>** internal control review of financial aspects?</p> <p>** internal control review of non-financial aspects?</p>			

Questionnaire	Yes	No	Remarks
<p>v - if operating areas are subject to audits,</p> <p>** what operational areas are covered</p> <ul style="list-style-type: none"> = finance = production = sales = purchasing = stock control = personnel = marketing = E.D.P. = other <p>** do these audits include an evaluation of overall performance of the operating units from the standpoint of:</p> <ul style="list-style-type: none"> = plan of organisation? = policies in effect? = procedures being followed? = results = reporting on individual employees' performance? 			<p>E M L</p>
<p>** <u>Give examples</u></p>			

Questionnaire	Yes	No	Remarks
<p>(b) if "No", examine audit reports by reference to audit programmes of work to be done in each audit, in order to obtain the required information in (a) (above).</p> <p>(2) (a) Is there in existence an up-to-date organisation chart showing the overall structure and management of the organisation, as well as the duties, and lines of responsibility of its key personnel (if so, obtain copies)?</p> <p>(b) If not, with assistance of the audit manager, prepare an organisation chart, supplemented by brief notes illustrating as clearly as possible the required information in (a) (above).</p> <p>(c) Review the charts or notes obtained or prepared in (a) or (b) (above) and, consider the following:-</p> <p>i - to whom does the audit manager report organisationally,</p> <p>= chief executive?</p> <p>= audit committee?</p> <p>= finance director?</p> <p>= chief accountant?</p> <p>= other, (specify)</p>			

ii - What circulation is given to audit reports in the organisation concerned (fill in the appropriate column in the following distribution sheet)?

<u>Distribution:</u>	Take action	Secure action	Inform- ation	Reviewed prior to release
<ul style="list-style-type: none"> [= Chief Executive (President) = General Manager (Senior V.P.) = Director General Manager (V.P.) 				
<ul style="list-style-type: none"> [= Director of Finance = Financial Controller [= Chief Accountant 				
<ul style="list-style-type: none"> [= Audit Committee [= General Auditor 				
<ul style="list-style-type: none"> [= Manager of the audit area. = Superior of the manager of the audit area. = Managers from whom action may be required. 				
[= External Auditors				

Comments:

(3) (a) Are there in existence time records showing the use of internal audit staff time spent on each audit in the organisation concerned?

YES

NO

(b) If "YES", out of the total time spent on an audit, what is the percentage spent on:

i - preparation stage?

ii - field work?

iii - report writing?

iv - review of findings with management?

(c) If "NO", with assistance of the audit manager, obtain the estimated, approximate time for each item in (b) (above) as clearly as possible.

(d) Using the information prepared or obtained in (b) or (c) (above), by reference to current audit work schedules and by discussion with the audit manager, what is the percentage of time spent on:- %

= Involvement with accounting work?

= Involvement with internal check work?

= Involvement with internal control reviews of the financial aspects?

= Involvement with internal control reviews of non-financial aspects?

= Special audit investigation?

Section (2): Analysis of audit points made to management in the organisations concerned

Q.(4) How many internal audit reports on the organisation's activities have been produced over the past 3-5 years?

Year	Number of audit reports
19	
19	
19	
19	
19	

Q.(5) Do the reports cover a description of the audit work and findings/recommendations or only matters requiring attention?

Description	<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
Attention items	<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
Both	<input type="checkbox"/>	YES	<input type="checkbox"/>	NO

Q.(6) Do the reports include a summary of findings?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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Q.(7) Examine each audit report and determine:-

- The number of audit points (i.e. recommendations) made in connection with each area or function served, (Work Sheet (I) Column(I)).
- The number of audit points made in connection with the levels of management whose work would be affected by the audit points made, (Work Sheet (I) Column (2)).
- The number of audit points made by reference to types of audit carried out (Work Sheet (I) Column (3)).
- The number of audit points which (i) directly (ii) by implication, comment on the quality of management rather than (iii) on the efficiency of management systems, (Work Sheet (2)).
- Follow up the audit points made with respect to (i), (ii) and (iii) in (d) (above), to look for evidence of management reaction, and whether or not the point was acted upon, (Work Sheet (3)).

Q.(8) Do the reports include a statement of the auditor's overall opinion or general conclusion concerning the audit area?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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(a) If "YES", does it encompass and is it responsive to:
= the title (i.e. topic) of the report?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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= the audit objectives spelled out in the report?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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= an indication of praise?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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= an indication of criticism?

<input type="checkbox"/>	YES	<input type="checkbox"/>	NO
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(b) If "NO", to be discussed with the audit manager.

Q.(9) What is the relative emphasis of audit points made?

(a) = Organisational aspects?

= Procedural aspects?

(b) = Observations on weaknesses?

= Recommendations for improvement?

(c) = Praise?

= Criticism?

(d) = Relevant to the objectives of audit?

= Irrelevant to objectives of audit?

(e) = Relating to pre-event audits?

= Relating to historical event audits?

	YES	NO
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Work Sheet (I) : Classification of Audit Points Made to Management

(I)

(2)

(3)

Report date	No. of audit points	Areas served "Functions"	Management Levels			Type of audit		
			A	E	LM	I.CH	I.C.R.	F.A N.F.A
			Administrative & Upper Executive Levels					
			Executive Levels					
			Lower Managerial Levels					
			Internal Check Work					
			Internal Control Reviews "Financial Aspects"				F.A	
			Internal Control Reviews "Non-Financial Aspects"					N.F.A

Work Sheet (2): Classification of Audit Points Made to Management

Report Date:		Ref:		
Management Levels	Number of Audit Points Which Comment on:			
	The efficiency of management systems		The quality of management itself	
	Directly	By Implication	Directly	By Implication

Work Sheet (3): Number of Audit Points Made by Reference to
Management Reaction and Appreciation

Ref.

Report Date	No. of audit points	Management Reaction			Remarks
		Favourable	Indifferent	Hostile	

Appendix (E)

Background Data on Research Areas
Hypotheses, and Relevant Sources of
Empirical Research Evidence

The empirical framework of the research and sources of research information are outlined in Chapter (3).

In this appendix, some clarifications are added to show the way in which research areas and related hypotheses were organised and developed in connection with relevant sources of empirical research evidence.

Each research area has been divided into a set of basic hypotheses, and each hypothesis was also divided into a set of variables. All questions in the questionnaires used were converted to these variables and finally linked with their relevant research areas and hypotheses. The following is a detailed illustration of this process.

Research Area No.1

Internal audit coverage by management function.

Hypothesis 1.1

The scope of internal audit is changing to include non-financial audit areas.

Relevant variables

- (i) Internal audit managers' variable list.
V20, V21, V22, V23, V24, V25.
- (ii) Executive managers' variable list.
V1, V2, V9.
- (iii) Audit reports' variable list.
V12, V13.

Hypothesis 1.2

The extent to which non-financial areas are audited is related to the line and functional reporting relationships of internal audit.

Relevant variables

(i) Internal audit managers' variable list.

V2, V3, V4, V5 and V42.

(ii) Executive managers' variable list.

V11.

(iii) Audit reports' variable list.

V14, V15, V16 and V18.

Research Area No,2

Internal audit coverage by management level.

Hypothesis 2.1

Most internal audit work is concerned with the activities of lower management.

Relevant variables

(i) Internal audit managers' variable list.

V10, V11, V12, V13, V14, V15 and V16.

(ii) Executive managers' variable list.

V3, V4, V5, V6, V7, V8, V19 and V20.

(iii) Audit reports' variable list.

V17.

(iv) Audit managers' interview schedule.

V3.

Hypothesis 2.2

Internal audit attempts to confine itself to the review and appraisal of management systems rather than to a review and appraisal of the individuals doing the managing as (i) this is the nature of the accepted audit task, and (ii) this helps to avoid alienating internal audit from other management.

Relevant variables

- (i) Internal audit managers' variable list.
V13, V14, V15, V16, V17, V26, V27, V28,
V29, V30, V31, V51, V52, V53, and V54.
- (ii) Executive managers' variable list.
V1, V2, V9, V11, V15, V16, V17 and V18.
- (iii) Audit reports' variable list
V19.
- (iv) Audit managers' interview schedule.
V1, V2, and V3.

Research Area No.3

The nature of internal audit points made to management.

Hypothesis 3.1

Most of internal audit's recommendations for systems changes which are designed to improve internal control are made by an analysis of historical happenings. While the recommendations for systems changes are designed to influence the future functioning of management systems, internal audit rarely appraises the forward planning systems of the organisation and thus misses a major opportunity to influence future events. Occasionally internal audit makes a post-project review of forward planning by comparing actual with budget (i.e. an audit of historical happenings) but it is almost unknown for internal audit to appraise corporate plans relating to a future which has not yet occurred.

Relevant variables

- (i) Internal audit managers' variable list.
V18, V19, V32, V33, V34, V60, V61, V62,
V63, V64 and V65.
- (ii) Executive managers' variable list.
V1, V2 and V11.
- (iii) Audit reports' variable list.
V24.
- (iv) Audit managers' interview schedule.
V2 and V3.

Hypothesis 3.2

Internal auditors are generally successful in making audit recommendations which:

- emphasise the basic protective aspects of the operations reviewed as well as contribute to the improvement of these operations.
- help auditees to recognise their own problems and inefficiencies.

Relevant variables

- (i) Internal audit managers' variable list.
V6, V7, V8, V9, V35, V36, V37, V38, V39,
V40, V41, V43, V44, V45, V46, V47, V48, V49,
V50, V55, V56 and V59.
- (ii) Executive managers' variable list.
V10, V12, V13 and V14.
- (iii) Audit reports' variable list.
V1, V2, V3, V4, V5, V6, V7, V8, V9, V20,
V21, V22 and V23.

(iv) Audit managers' interview schedule.

V4, V5, V6, V7, V8 and V9.

The following is a complete list of each set of variables with reference to their relevant part(s) of the questionnaires used.

Sources of empirical research evidence

Internal Audit Managers' Variable List

Variable List	Variable Description	Relevant Part of Questionnaire
V1	Types of organisations participating in the study.	Q.2(a)
V2	Total number of employees in the organisations concerned.	Q.2(b)
V3	Auditors' background - Number of accountants as auditors	Q.4(a)
V4	Auditors' background - Number of non-accountants as auditors.	Q.4(b)
V5	Number of clerical & secretarial staff	Q.4(c)
V6	Management Policy Statement	Q.5
V7	Review of audit long-range plans with higher management	Q.6(a)
V8	The relative emphasis of management control systems of audit schedules	Q.7(a)
V9	The relative emphasis of general statements of auditing theory and practices in audit schedules.	Q.7(b)
***	Subjection of management levels to internal audit:	Q.8
V10	= Administrative & Upper Executive Levels	Q.8(a)
V11	= Executive Levels	Q.8(b)
V12	= Lower Managerial Levels	Q.8(c)
V13	Internal audit managers' attitude towards appraising the quality of performance in carrying out assigned responsibilities	Q.9(a)

Variable List	Variable Description	Relevant Part of Questionnaire
***	Extent of appraising the quality of management performance as seen by audit managers at:	Q.9(b)
V14	= Administrative & Upper Executive Levels	Q.9(b)(i)
V15	= Executive Levels	Q.9(b)(ii)
V16	= Lower Managerial Levels	Q.9(b)(iii)
V17	Extent of reviewing existing management control systems	Q.10(i)
V18	Development & installation of new systems and procedures	Q.10(ii)
V19	Review of newly developed or revised systems & procedures prior to their adoption.	Q.10(iii)
V20	Review and appraisal of the organisational aspects.	Q.10(iv)
***	Operational Audit involvements:	Q.10(v)
V21	= Plan of organisation	Q.10(v)(a)
V22	= Policies in effect	Q.10(v)(b)
V23	= Procedures being followed	Q.10(v)(c)
V24	= Results	Q.10(v)(d)
V25	= Individual performance	Q.10(v)(e)
***	Evaluation of i. control systems:	
V26	= Management decision-making needs	Q.10(vi)(a)
V27	= Traditional aspects	Q.10(vi)(b)
V28	= Control of the overall phases of business operations	Q.10(vi)(c)

Variable List	Variable Description	Relevant Part of Questionnaire
	Audit managers' attitude towards the extent of scope of i. audit by reference to management level:	
V29	= Financial aspects of lower managerial levels.	Q.11(i)
V30	= Non-financial aspects of executive levels	Q.11(ii)
V31	= Reviewing tasks of administrative levels.	Q.11(iii)
V32	Pre-event audits/future plans	Q.12(a)
V33	Examples on pre-event audits.	Q.12(b)
V34	Non-audit methods to appraise future plans	Q.12(c)
V35	The frequency with which the functional mode is used as an audit style.	Q.13(i)
V36	The frequency with which the departmental mode is used as an audit style.	Q.13(ii)
V37	The frequency with which the management studies mode is used as an audit style	Q.13(iii)
V38	Audit styles used in actual practice	Q.14
***	Audit managers' attitude towards the main purpose of i. audit points made to management:	
V39	= Pointing out weaknesses	Q.15(i)
V40	= Identifying the problems and making recommended solutions	Q.15(ii)
V41	= Emphasising organisational aspects with less emphasis on procedural aspects	Q.15(iii)

Variable List	Variable Description	Relevant Part of Questionnaire
V42	Level of reporting	Q.16(a)
V43	Review of i. audit report drafts with auditees	Q.17(a)
***	Effect of reviewing i. audit report drafts with auditees on:	
V44	= The report's wording	Q.17(b)(i)
V45	= The reported findings	Q.17(b)(ii)
V46	= The proposed corrective action	Q.17(b)(iii)
V47	Appraising the quality of i. audit reports	Q.18(a)
V48	Measures used and suggested by i.a. managers for appraising the quality of i.a. reports.	Q.18(b)
V49	Extent of submitting i.a. reports to senior executives.	Q.19(a)
V50	Extent of submitting periodic summaries to senior executives	Q.19(b)
***	Discussion of reports calling for systems changes with:	
V51	= Senior Executives	Q.20(i)
V52	= The procedures people or systems analysts.	Q.20(ii)
V53	= Other related managers	Q.20(iii)
V54	Examples on changes in management systems as a result of i. audit recommendations	Q.21
V55	Responsibility for corrective action	Q.22(a-b-c)
***	Internal audit reporting practice:	
V56	= Level of reporting	Q.23(i)
V57	= Statement of objective and scope	Q.23(ii)

Variable List	Variable Description	Relevant Part of Questionnaire
V58	= Statement of the auditor's overall opinion	Q.23(iii)
V59	= Recommendations for corrective action with recommended officials to carry out the action recommended	Q.23(iv)
***	I. Audit Investigations Concerning Pre-event Audits:	
V60	= The soundness of the build-up of standards at the time they were formulated.	Q.24(i)
V61	= The decision to manufacture products with the laying down of the necessary plans.	Q.24(ii)
V62	= The decision to undertake capital expenditure projects.	Q.24(iii)
V63	= The control exercised over authorised capital expenditure	Q.24(iv)
V64	= The establishment of revenue expenditure budgets for the organisation.	Q.24(v)
V65	= The verification of accounting returns historical data and their relation to budgets, before they are submitted to management.	Q.24(vi)

Sources of empirical research evidence

Executive Managers' Variable List

Variable List	Variable Description	Relevant Part of Questionnaire
V1	Extent of changes in policies as a result of i. audit recommendations.	Q.4(a)(i)
V2	Extent of changes in systems as a result of i. audit recommendations	Q.4(a)(ii)
***	Timing of i. audit feedback (TAF):	
V3	= TAF During the audit	Q.5(i)
V4	= TAF At the end of the audit	Q.5(ii)
V5	= TAF From i. audit report drafts	Q.5(iii)
V6	= TAF From the final audit report	Q.5(iv)
V7	= TAF From superiors after the audit	Q.5(v)
V8	Extent of E. Managers' usual contact with i. audit.	Q.3(b)
V.9	Extent of E. Managers' satisfaction with the i. auditor's recommendations calling for changes in policies and systems.	Q.4(c)
***	Executive Managers' attitude towards i. audit reporting practice:	
V10	= Criticisms v Praise	Q.6(i)
V11	= Recommendations calling for systems changes	Q.6(ii)
V12	= I. Audit as a feedback process	Q.6(iii)
V13	= Relevancy of i. audit points to the original objectives of the audit	Q.6(iv)
V14	= Auditors' capability in making i.audit points which help auditees to recognise their own problems and inefficiencies.	Q.6(v)

Variable List	Variable Description	Relevant Part of Questionnaire
V15	Extent of i.audit's participation in evaluating the quality of performance.	Q.7(b)
V16	Extent of i. auditors' assistance in carrying out other managerial methods of evaluating the quality of performance.	Q.7(d)
V17	Other managerial methods to evaluate the quality of performance used by E. Managers.	Q.7(c)
V18	Is there in existence management systems employed in the organisations concerned to evaluate the quality of performance in carrying out assigned responsibilities?	Q.7(a)
V19	Tasks of E. Managers subjected to internal audit	Q.3(c)
V20	Examples on changes in policies and systems caused by i. audits.	Q.4(b)

Sources of empirical research evidence

Internal Audit Reports' Variable List

Variable List	Variable Description	Relevant Part of Questionnaire
***	Internal Audit Reporting Characteristics:	
V1	= Statements of audit objectives and scope	Q.1(a)
V2	= The nature of audit assignment	Q.1(a) (i)
V3	= Description of audit steps	Q.1(a) (ii)
V4	= Description of audit techniques	Q.1(a) (iii)
V5	= Description of audit work and findings/recommendations	Q.5
V6	= Summary of findings	Q.6
V7	= The auditor's overall opinion	Q.8
***	Analysis of the use of i. audit staff time according to audit stages:-	
V8	= Preparation stage	Q.3(b) (i)
V9	= Field work stage	Q.3(b) (ii)
V10	= Report writing stage	Q.3(b) (iii)
V11	= Review of findings with management	Q.3(b) (iv)
***	Analysis of the use of i. audit staff time by reference to i. audit phase and year:	
V12	= Internal Check Work	Q.3(d) (ii)
V13	= Internal Control Reviews - F.A.	Q.3(d) (iii)
V14	= Internal Control Reviews - N.F.A.	Q.3(d) (iv)
V15	The Level of Reporting	Q.2(c) (i)&(ii)
V16	Analysis of i.a. points by area served.	Q.7(a)
V17	Analysis of i.a. point by management levels	Q.7(b)

Variable List	Variable Description	Relevant Part of Questionnaire
V18	Analysis of i.a. points by audit phase	Q.7(c)
V19	Analysis of i.a. points to distinguish between comments on the quality of management and the efficiency of systems.	Q.7(d)
***	Analysis & Weighting of i. audit points between:-	
V20	= Organisational vvs. Procedural	Q.9(a)
V21	= Observations on weaknesses vvs. Recommendations for improvement	Q.9(b)
V22	= Praise vvs. Criticism	Q.9(c)
V23	= Relevant to objectives vvs. Irrelevant to objectives	Q.9(d)
V24	= Relating to Pre-event audit vvs. Historical audits.	Q.9(e)

Sources of empirical research evidence

Interviews Schedules' Variable List

Variable List	Variable Description	Relevant Questions
V1	Auditors' priorities in audits of management levels in terms of financial and non-financial aspects at each level.	Q.1(i)(a)
V2	Nature of the audit appraisal at each management level: V21 management controls V22 management decisions V23 individual performance V24 technical aspects	Q.1(i)(b)
V3	Difficulties of auditing management levels	Q.1(ii)
V4	Addressee of audit reports	Q.2(i)
V5	Reporting the auditee's views about audit points made	Q.2(ii)(a)
V6	Reporting satisfactory conditions	Q.2(ii)(b)
V7	Internal audit effort in developing employees	Q.3
V8	Co-ordination with the external auditor	Q.4(i) and (ii) and (iii)

Appendix (F)

Management Control and Internal Auditing

Preface

Reference has previously been made to the problem of terminology in the various fields of business, how different terms shall be used and whether individual terms are viewed narrowly or broadly.

In fact, the complexities of any term as a concept are such that the word inevitably carries a number of acceptable meanings, depending upon the viewpoint, beliefs, and comprehension of the user. A divergence in views, therefore, is not to be wondered at. But as long as the terminology in use varies among writers any user should state clearly what he means.

In this context, the management of a business enterprise entails an orderliness and a rational character that is at least partly expressed in the concept of control. Like all managerial actions, the importance of control lies in the necessity for maximising the use of scarce resources and in the need for order and system in the purposeful behaviour of men. Probably, this process is the most integrative part of the entire management process and represents a major responsibility of every manager and one where he needs every possible assistance; and logically this assistance should come from internal auditing which is in itself an important type of control.

For the internal auditor, the importance of the control function comes from the fact that the review and appraisal of controls is normally a part - directly or indirectly - of every type of internal auditing assignment. Even more, it is asserted that the internal auditor's special competence in the control area is what justifies his review of a broader scope of operational activities, even though he does not possess special knowledge

about the technical aspects of those activities.

The purpose of the following discussion is to probe more closely certain aspects of control theory particularly relating to the main research areas of this study.

Regardless of the problem of terminology which exists in the area of control, the term "control" is viewed as the general term which covers all types of control and which needs further identification as to the particular type of control. From this standpoint, the following discussion will be developed with special emphasis on aspects of the management process which pertain to the control function and their effect on the work of the internal auditor. This is followed by a brief summary of each managerial term used in the study.

(1) General trends in the development of control

Control has been defined in various ways depending upon the viewpoint, beliefs, and comprehension of the definer. A review of management literature revealed that control was first understood as "exercising a directing, guiding, or restraining power."⁽¹⁾

Fayol, in his pioneer study of managerial or administrative functions, listed control along with planning, organising, commanding and co-ordinating as the activities of management.⁽²⁾

With the scientific management movement, however, a central emphasis was placed upon the basic functions in the process of management. According to this change, control was viewed as a complete process in light of its interrelationships with other fundamental managerial functions (see: 2 and 3 hereafter).

As such control as a process "is determining what is being accomplished, that is evaluating the performance and, if necessary, applying corrective measures so that the performance takes place according to plans."⁽³⁾

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- 1 Hoverland, H.A. and Stricklin, W.D. "Management and Accounting Concepts of Control", (Management Accounting, June, 1967).
 - 2 Fayol, H., "General and Industrial Management", Translated by Constance Storrs, (London: Sir Isaac Pitman, 1949).
 3. Terry, R.G., "Principles of Management", (Illinois: Richard D. Irwin, Inc., 1972), p.555.

Different words traced the same pattern:

"Control is the process of seeing-to-it that the operating results conform as nearly as possible to the plans made to meet the company's objectives."(4)

The next stage of development in this area was, however, to shift the emphasis to achieving the objectives of the organisation by ensuring that the performance not only takes place according to plans but that the plans themselves are developed, improved, and brought about the desired end results. (5)

Objectives, as such, are not just a basis for directing efforts but can be a tool for generating the will-to-do, enthusiasm, and teamwork by the members of an organisation. Nevertheless, there was the general recognition that in many cases the objectives fail to provide this added 'spark' to attain objectives.

Why? Mainly because the manager does not clearly communicate the objective, the scope within which the subordinate has to exercise decision making is too narrow, and/or the major problem areas are not given preferred attention. (6)

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- 4 MacPhee, E.D., "The Role of the Internal Auditor in the Control Process", (The Internal Auditor, March 1956), p.28.
 - 5 Churchill, N.C. and Teitelbaum, L.N., "Auditing and Managerial Control - A Hypothesis", in: M. Alexis and C.Z. Wilson (eds), "Organisational Decision Making", (N.J. Englewood Cliffs: Prentice-Hall Inc., 1967).
 6. Terry, R.G., op. cit., pp.49-50.

To correct these shortcomings, participation in formulating an objective by its user is utilised.

This participative objective-setting approach has gained many followers. It has developed into an entire approach to management, and is sometimes referred to as management by objectives, management by mission, goals management, or results management.⁽⁷⁾

This approach gave a new look at control. When appraisal by results is made, control becomes more meaningful and acceptable by employees, and viewed as a strong motivator which can be used to the advantage of both employees and the organisation they serve.

The practice of this view has resulted in the wide use of the managerial principle of exception in controlling. Control was expedited by concentrating on the exceptions or outstanding variations, from the expected result or standard.⁽⁸⁾

Closely akin to controlling by the exception principle, is approaching the process of control by concentrating on the use of key points or major activities in the enterprise. Proponents of this view believed that any attempt to include all facets of an enterprise into a control system results usually in too many figures to compile and watch, too many details, and

7 Idem.

8 Ibid., p.548. See also: Koontz & O'Donnell, "Principles of Management: An Analysis of Management Functions", (New York: McGraw Hill Book Company, 1972), Chapter 23.

too much time spent on attempting to control relatively minor activities.

An effective and simple answer, in their opinion, is to confine control to activities around key points to provide a meaningful review.⁽⁹⁾

Actually, this was possible in the case of small and relatively large organisations where management could possess a relatively detailed knowledge of most facets of the operations. Gradually, however, it soon became obvious that this approach was no longer workable in controlling multi-unit organisations. Accepting only control over each separate unit as being sufficient can lead to autonomy of the enterprise so that the enterprise eventually will consist of small units rather than one integrated large unit. But viewing the entire organisation as an integrated unit and controlling its activities from a single vantage point will make it possible to achieve a greater co-ordination and control; and thereon the need for overall managerial performance control became apparent.

That put "control" into a different light. The "big picture" is now emphasised, and the entire business must be seen, understood, and managed as an integrated process with effective communication.⁽¹⁰⁾ Only in this manner can a

9 Terry, R.G., op cit., pp.535-555.

10 Peter, F.D., "The Practice of Management", (New York: Harper & Brothers, 1954), pp.370-371.

balanced and co-ordinated programme with specific objectives and a controlling plan be established.⁽¹¹⁾

Here, thinking in terms of systems was helpful to simplify the concept of the multitudinous activities that management must work. Actually, the systems school and the concepts it brought have greatly affected the theory of control. Looking at the organisation as a whole system, an integration of the various controls employed can be obtained; meantime, control over each separate unit is available to keep the respective elements of performance within the desired limits. Also, the idea of "feedback" has become a central concept in the theory of control. It is a process by which systems gather information about how they are doing, feeding the information back into system to guide, direct, and control its further operations.⁽¹²⁾

From this standpoint, a management control system has been defined as:

"a system of organisational information seeking and gathering, accountability and feedback designed to ensure that the enterprise adapts to changes in its substantial environment and that the work behaviour of employees is measured by a set of operational sub-goals (which conform with overall objectives) so that the discrepancy between the two can be reconciled and corrected for."⁽¹³⁾

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- 11 Norbeck, E.F. et al, "Operational Auditing for Management Control", (USA: American Management Association, Inc., 1969), p.45.
 - 12 McFarland, D.E. (1), "Management: Principles and Practice", (New York: The Macmillan Co., 1971), p.311.
 - 13 Lowe, E.A., "On the Idea of a Management Control System: Integrating Accounting and Management Control", (The Journal of Management Studies, Vol.8, No.1, Feb. 1971).

The vital part in this system is an information feedback designed to reveal: (i) the magnitude of the discrepancy, relative and absolute, and more crucially (ii) whether plans should be modified in the light of events so as to better achieve objectives.⁽¹⁴⁾

One aspect of the control process which is increasingly important is that of emphasising both sub-objectives (i.e. those assigned to each separate unit) and overall objectives of the enterprise and the problem of fostering a desired balance among both individual and collective sub-unit tasks.

On the one hand, they should be linked together to form a total, controllable plan, hence it is often necessary to consider their interdependence. On the other hand, each unit within the functional areas is also a quasi-separate entity which has its own tasks and objectives. Both of these types of sub-unit activity are important, and a problem often arises when efforts to increase one type are made at the expense of the other (i.e. the dilemma of striking a balance between the needs for specialisation and those of co-ordination).⁽¹⁵⁾

What needs to be recognised here is that thought given to this problem has led in a significant way to evaluate sub-units (i.e. operational areas) performance from the standpoint of both their efficiency and effectiveness - an increasingly important area of the internal auditor's interest.

14 Idem.

15 Baumler, J.V., "Defined Criteria of Performance in Organisational Control", (Administrative Science Quarterly, Vol.16, No.3, Sep. 1971)

A distinction has been made in the literature between each separate unit's effectiveness (i.e. the extent to which a separate unit within the company produces the intended result in conformity with the overall objective of the organisation), and its efficiency which is, per se, not related to the objectives. An operating unit, for instance, could be run efficiently (i.e. achieves its objective with the lowest consumption of resources), yet, to a certain extent, ineffectively when this efficiency has been done at the expense of other operating units or generally without regard to the adverse effect on them - see (8) hereafter.

With these ideas, two types of control have been identified as follows: ⁽¹⁶⁾

- (i) Control-in-the-small, which involves some sort of standard of behaviour and an explicit or implied imperative to individual to meet or better this standard. This type of control could be linked with efficiency, and
- (ii) Control-in-the-large, which generally involves a total business systems approach and the specification of certain rules or procedures within the system. This type of control could be associated with effectiveness.

16 Bonini, C.P., et al (eds), "Management Controls: New Directions in Basic Research", (New York: McGraw-Hill Book Company, 1964).

With this swift scan of the general trends in the development of control, it is reasonable to conclude that control becomes viewed as an integrated process based on a control-in-the-large approach. Emphasised are the efficiency and effectiveness of the organisation as a whole with equal emphasis on an effective communication system which feeds back the information to guide, direct, and better control the organisation's future operations.

In so far as the field of control is the main interest of the internal auditor, we are, therefore, very much concerned with understanding these developments in the control function and what effect they have on the work of the internal auditor, and this brings us to the following discussion.

(2) The basic nature of control

One of the interesting things about the term "control" is how differently it is used in various situations, and it seems that much of the basic difficulty in developing a comprehensive concept of control lies in failure to recognise that it can take several different forms. This is so because an understanding of control is dependent on the understanding of the art and science of management as a whole. The critical issue, therefore, is what is the common nature of the control function as it applies to the world of management?

It is believed that an answer to this question can be best understood and illustrated in terms of the major phases of the management process. Management as an

internal organisational process has been defined as follows:

"Management is a distinct process consisting of planning, organising, actuating, and controlling, performed to determine and accomplish stated objectives by the use of human beings and other resources."(17)

Consequently, management is viewed as the performance of certain functions that constitute a continuous process.

This process begins with planning and the establishment of objectives. This planning is then supported by organising and staffing activities. Managers then take the definitive operational actions to accomplish the predetermined objectives. But things seldom work out exactly as planned and thus supplementary measures and actions are needed to provide appropriate readings on the progress made and to provide the basis for further actions which will better assure the achievement of the previously established objectives. The control function is concerned with providing these supplementary measures and actions, and from this point of view control constitutes the particular means by which management measures and evaluates the various types of operational performance.

(3) Relation of control to the total management process

An important implication is that the fundamental functions of management process are inextricably interwoven

17 Terry, R.G., op. cit., p.4.

and interrelated, the performance of one function does not cease entirely before the next is started and they normally are not carried out in a particular sequence but as the situation being considered seems to require. For instance, planning is concerned with determining sound objectives for the organisation as a whole and for each operational unit. These objectives in total, and in the case of each operational unit, provide the points of reference for the supporting control activities. Hence, complete and overall planning provides the foundation for the control function. Most managements are aware of the need for sound planning. Equally, anyone interested in developing or improving effective control must necessarily be concerned with both the adequacy of the design for planning and the effectiveness with which it is actually carried out.

It is important, therefore, that those who are responsible for controlling should have a say during the design stage as to the choice of the way in which control actions are to be effectively carried out in the particular operational areas to be controlled - see: Sec. 2.3.2, see Also Sec. 7.1.2.

It is through organising that work assignments are made, authority delegated, and accountabilities determined.

In this way organising provides the basic framework for control. More specifically, the organisational responsibilities of individuals and organisational units make possible the more systematic identification of

objectives and the measurement of operational results. Once again, this means that, for the control function to be effective, proper considerations must be given as to the soundness of organisational design and related organisational arrangements - see: Table (7.8).

On the other hand, the control function is accomplished both by and through people. Accordingly, where there are capable managers the administration of control functions will be done in a more effective way. And this means that achieving effective control requires a close partnership with responsible managers so that actions in operational areas are supportive of control needs - see: Sec. 7.2.3 et seq.

(4) Application at all management levels

The relation of control to the management process has another significant dimension, that is control is applicable at all organisational levels. Figure (1) depicts the various levels of management within an organisation structure schematically. It denotes the fact that organisations tend to take a pyramid form, because with successively higher levels, fewer persons are needed. These fewer persons, however, are managers and executives with increasingly broad and heavy responsibilities.

The terms used in Figure (1) require explanation.

Practice in different organisations vary greatly, for example, as to how internal individual organisational responsibilities are defined and what is really meant by individual titles. This would evidently bear upon the

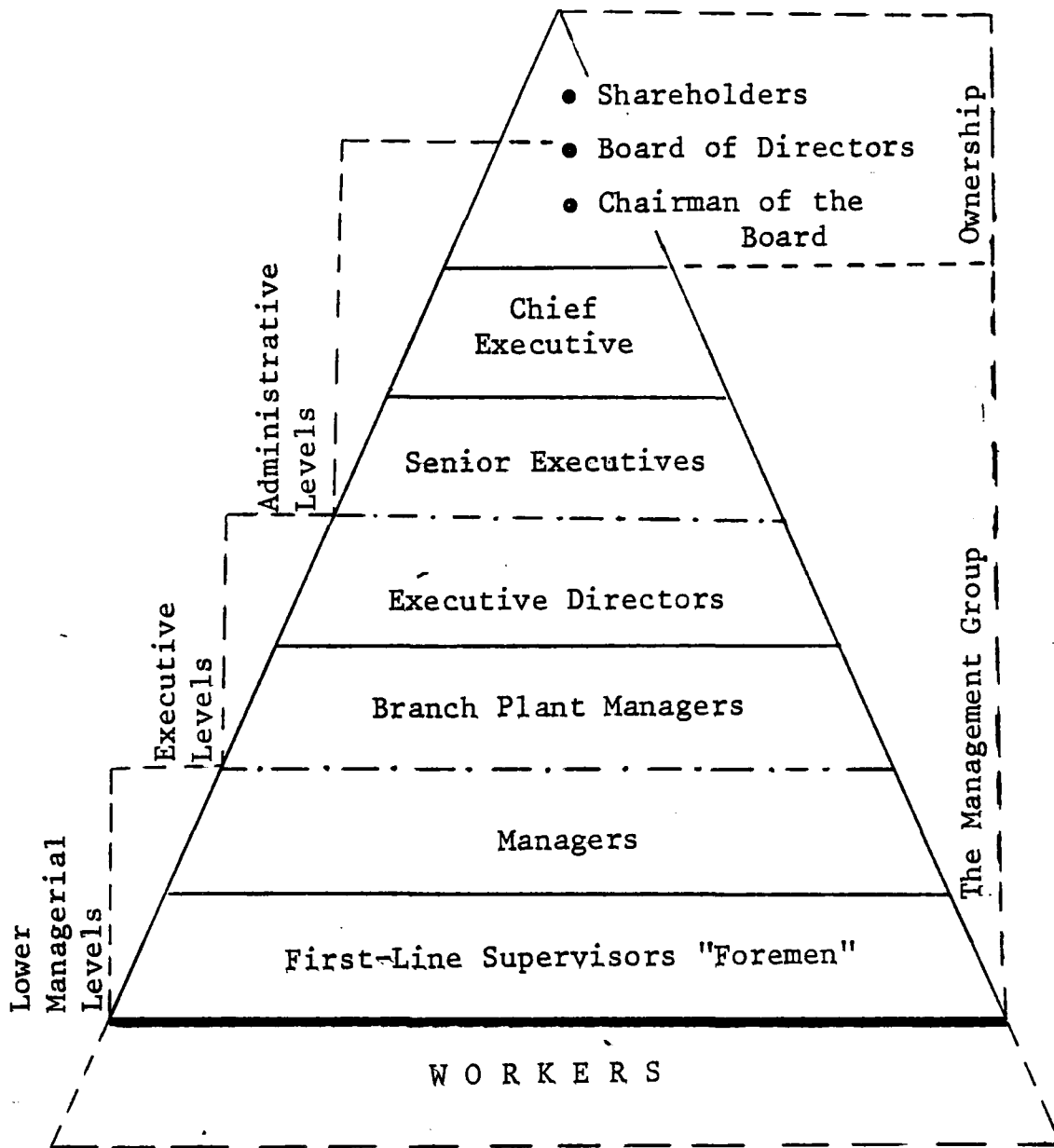


Figure (1) The Organisational Groups

overall organisational structure in each particular case. It should be noted, therefore, that the levels described in Figure (1) are representations only.

Figure (1) shows that the management group includes all levels below that of ownership level and above that of the workers. In other words, it begins at the chief executive level and includes all those who are designated foremen.

The topmost level consists of one person, the chief executive (i.e. the managing director). Usually his title is "President", but occasionally the top operating position will be "General Manager", or "Executive Vice-President", or in a few cases, "Chairman of the Board". In the latter case, the company president is usually absent from, or inactive in, the business or is directing one or more additional activities. (18)

The level below that of chief executive consists of other selected senior executive (e.g. Senior Vice-President and/or Deputy General Manager), In some people's mind, these first two levels are considered together as the top management group. (19)

Technically, however, in corporations the group at the top of the company structure is known as the Corporate Officers, and includes in addition to the first two levels shown in Figure (1) the chairman of the Board

18 McFarland, D.E. (1), op. cit., p.339.

19 Idem.

and Board members. In this study, this group is considered as the top management group and called Administrative and Upper Executive Levels. These higher management levels are concerned primarily with the major direction of the company, large scale and long-range strategies, overall policies, legal matters, the choice of major objectives, and the profitability that ensues from all these elements.

The next two levels in Figure (1) represent what is sometimes called Operating Management. These positions are held by Executive Directors or Vice-Presidents or other "Senior Managers" who head up the major activities, departments, or divisions in the company, and also includes Senior Managers in charge of branch plants. In this study, this group is called Executive Levels who are mainly responsible for the execution of policies, plans, and with the implementation and communication of basic Administrative decisions respecting objectives and policies. They perform the top-level and day-to-day management of the company, with broad responsibility for major actions affecting the organisation's success.

Frequently, corporate officers are elected to their posts by other officers. When an executive director is elected to be one of the Board members in addition to his executive responsibilities, he is then more likely classified in the Upper Executive category in his organisation.

The next two levels in Figure (1) refer to Lower Managerial Levels. Managers usually have less discretion

in the manner of carrying out their duties and less influence in policy decision than executives. Their function is to carry out operating plans and policies within the framework of plans and policies developed by other higher levels.

Also, among these lower levels are the foremen or the first-line supervisors. The wide black line in Figure (1) represents the strong degree of contrast between the responsibilities of workers and those of foremen. A foreman is usually eligible for advancement to general foreman, which would involve supervising a number of other foremen.

Figure (1) also shows ownership levels. Owners exercise control over the management group by direct supervision or, as in the case of corporations whose stock is held by large numbers of persons, by choosing members of the board of directors. Board members usually take little or no part in the direct operations of the business. The board takes action on matters referred to it by managers and carries out actions approved by stockholders. Its actions are concerned with the safety and profitability of the business, with its major policies, and the direction in which it is moving. The board's decisions and policies are transmitted to the management group through channels of communication that are headed and co-ordinated by the corporation's chief executive. (20)

20 For detailed information on boards of directors, See: Koontz, H., "The Board of Directors and Effective Management", (New York: McGraw-Hill Book Company, Inc., 1967) Also: Bacon, J. "Corporate Directorship Practices", (New York: National Industrial Conference Board, 1968).

The owners, through the board of directors, look to the management group for managing the business in such a way as to produce a profit and protect the security of their investment. Profits, from their point of view, are the test of an efficient management group, and prolonged failure to make profits will result in efforts by the board to improve the quality of the management group.

(5) Aspects of the control process & Management as controllers

As indicated earlier, management is concerned with the operation of the business enterprise as a whole, and its constituent units. Within such a structure management have to look at the functioning of the organisation as a whole, as the adapting and integrating of parts.

If this type of analysis is extended further to include individual decisions and actions, the study will not be effective by dealing with separate decisions and actions only, but also by understanding their relationships. As they influence each other, they form a continuous process of interaction within the business operations. This feature emphasises the need for co-ordination between managers who influence policy (i.e. administrative levels) and those who are mainly responsible for the execution or the implementation of these policies (i.e. executive and lower managerial levels) in order to have a unity of objective.

In this process, management is moving from one situation to another by formulating one plan after another. In the transition from one to another, certain problems are

encountered concerning the choice of the specific course of action and the adjustment of existing situations. Once these problems are studied and a decision is made, other problems come to light, namely those of action (i.e. execution). Thus, we have the three aspects of the control process in terms of the nature of problems they face:- (21)

- | | | |
|----------------|---|------------------------------------|
| (1) Choice | } | To decide about course of action . |
| (2) Adjustment | | |
| (3) Action | } | To execute plans. |

The first two aspects refer to the making of decisions and reside within the sphere of administrative levels as they are policy makers, planning and organising-designers. The third aspect relates to the function of executive management.

(6) Control and internal auditing

1. Control is a function of management, of the individuals who make decisions and those who are on the spot of action with authoritative powers to take and get action when needed.

Control can thus be exercised only through people who have responsibilities for, and authorities over, certain jobs and functions. The more such managerial functions are defined in terms of responsibilities and authorities within each organisation, the more control will be effective.

21 Hegazy, A.M., "Accounting for Managerial Control", (Cairo: AL Nahda EL Arabia Bookshop, 1969), p.11.

2. Control consists of the individual controllers at all management levels, and all auxiliary mechanisms which enable them to maintain the process of control. Among these mechanisms, internal audit reviews and appraisals assume a paramount importance because of their wide scope of operation, which potentially includes all aspects of business. The internal auditor, whatever his status may be in the organisation, does not control other functions - he maintains control only over his function. His reviews and appraisal do not constitute control, but enable others to work within rational boundaries. On the other hand, the internal auditor is associated with all managerial controllers and his reviews and appraisals provide them with guides which can help them to carry out their functions.
3. Individual controllers contribute in one way or another to the formulation of policies and plans, each one introducing his own experience with the sense of responsibility which is given him for the realisation of certain objectives. They are only agents accountable for the sources of success or failure of their own functions.

The internal auditor is more concerned with the systems of control rather than the people who doing the managing. However, without co-operation between him and individual controllers, he would not be able to present the guides of control properly, and if presented to them, they would be of no value as they would not be used. Therefore, the internal auditor's interest should be

directed not only to systems of control, but also to the responsible individuals acting in the capacity of controllers.

4. Resulting from the above, for a better understanding of the control functions it would be helpful to define the functions of individual controllers either as policy-makers, planning and organising-designers and/or executives. The internal auditor's relationship with each group will be determined then in terms of demands and supplies of data passing to and from these individual controllers, coupled with his recommendations which are designed to lead to a more efficient, effective or economic methods and thus helping the organisation to meet its objective.
5. The internal auditor is committed to organisation service, therefore, he is interested in the control effort as a means of furthering his objective of organisation service. The basis for his special capability in the control area to a major extent comes from the fact that he is independent of all operational activities but at the same time exposed to them. This provides the necessary objectivity and the overview of all operational activities, their interrelations, and the related controls; and the foundation is thus laid for a greater service at all management levels.

(7) Ways of approaching control

It may be useful at this point to indicate the factors in the control process which are significant for

the purpose of designing the control mechanism. These factors can be approached via differing channels, viz:

- (a) The tracing of the flow of managerial decisions and actions

Decision making is both a managerial function and an organisational process. Decision making is managerial in that it is a fundamental responsibility of the manager himself. It is organisational in that decisions often transcend the individual manager and become the product of work teams, groups, boards, or even of machines and computers. A decision is thus the focal point of both managerial and organisational action. (22)

Management decisions takes many forms; however, one classification which seems popular and closely related to this discussion is that of looking at decisions as to whether they are basic or routine. (23) Basic decisions involve (i) long-range commitments of relative permanence or duration, (ii) large investments or expenditures of funds, and (iii) a degree of importance such that a mistake would seriously jeopardise the welfare of the business. Examples of basic decisions would be plant location, the decision to manufacture products, policy decisions also fall in the category of basic decisions

22 McFarland, D.E. (1), op. cit., p.75.

23 Ibid., pp.81-85. Borrowing from the language of computer, these two types of decisions sometimes referred to as Programmed and Nonprogrammed Decisions - See: Simon, H.A., "The New Science of Management Decision", (New York: Harper and Row, Publishers, Inc., 1960), pp.5-8.

because they govern other decisions and are likely to be relatively permanent and far reaching in their effects. Decisions on organisation structure and design have profound effects on the interrelationships and activities of people. Such decisions must also be considered basic.

Routine decisions are those which require relatively little deliberation or which are made repetitively. They tend to have only minor effects on the welfare of the business. Procedures can be established for making large numbers of this kind of decision. Decisions of this kind require little investigation and analysis, and can easily be cancelled or reversed.

(b) The tracing of the flow of business operations

Approaching control from this angle tends to concentrate more on processes flowing through the organisation. This is sometimes desirable because individual managers vary in their abilities and interests, and approaching control according to the processes performed can thus focus their work around departmentally organised activities. This is also desirable in order to channel the efforts of the managers who direct and control the work being done.

(c) The follow-up of the flow of monetary values

This is a common approach to the control function. The main idea here is that any control's method of approach should be for the objectives of correlating management decisions and actions with the financial results evolving therefrom. In some people minds, the central management control system should be approached from this angle since

money is a common denominator.⁽²⁴⁾

(d) Design and Implementation

Another useful way to approach the control function is in terms of the dimensions of design and implementation.

Design has to do with the selection of the particular operational aspects to be controlled, the determination of the extent to which these aspects are to be controlled, and the choice of the way that control actions are to be carried out.⁽²⁵⁾ Such a design effort of course takes into account the later implementation of the system, but it tends to focus more on the basic dimensions of managerial needs. Thus, a particular type of standard is determined, a procedure for measuring results is established, and a programme is laid out for review, appraisal, and further possible action.

The second phase of the control system then has to do with the actual implementation of the system and the subsequent administration of it. The focus here is on the actual performance and the people who are involved. At this stage the need is for administrative skill and judgement to deal with the many unforeseen developments and the unavoidable human problems - internal auditing has a

24 Anthony, R.N., "Planning and Control Systems: A Framework for Analysis", (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1965).

25 Brink, V.Z., et al (2), "Modern Internal Auditing - An Operational Approach", (New York: The Ronald Press Company, 1973), p.61.

significant role in both of these interrelated phases of the control process.

(e) Protective and Constructive Aspects of Control

An additional way to approach controls is by considering their protective and constructive aspects, and then attempting to maximise as far as possible the latter. Controls to a large extent do serve to protect higher management levels from what goes on at the lower levels. For instance, some controls are designed particularly to prevent some kinds of action not desired by higher management levels. Illustrative of such undesirable actions would be the improper use of organisation property, the making of commitments beyond authorised levels, or even the improper preparing of a particular form. Some other controls are protective in the sense that higher management levels want to know of particular types of developments so that they can take defensive or corrective actions on a timely basis. In other cases, however, controls are viewed as a guide as to where some operational aspects might be improved.

Illustrative of such improvements would be defining control in a broader sense which would better motivate the people subject to the control, more understanding and sensitive administration of controls, or even by emphasising the positive benefits which normally follow control actions that are protective in nature (e.g. the emphasis on customer satisfaction and company reputation which is a result of protective type inspection measures). In all of these situations the objective of the control

specialist is to cover the protective needs in a way which avoids the emphasis in that direction, and instead to stress the constructive potentials.

(8) Problems of the control process

The sequence in which management levels deal with the problems of control can be summed up in terms of the three main aspects of the control process already explained.

Top echelons have to deal first with the problems of choice which include such decisions as the study of alternative choices of products and services and/or generally the choice of the economic course of action to be followed. The governing factor here is the economy of the choice in terms of economic costs and profits. In making this determination there are certain types of input which need to be provided and given proper consideration, also the specification of these objectives involves a proper determination of the time factor and an anticipation of the later need to measure performance against those objectives. The job of the control specialist here is to push the control function into new areas by a more capable analysis of the pertinent factors, and by perceptive determination of objectives.

Once a decision is made on the course of action to be followed, the question arises concerning the maintenances of effective balance between what is planned and actual realisation.

In this process, management focuses attention on standards of action and variances therefrom. The

controlling factor here will be the efficiency with which what is planned is executed.

Efficiency refers to the relation between what is decided upon and the realised results due to actual authorisations. In relation to standards, to be efficient means that either actual is equal to or less than the standard.⁽²⁶⁾ This is commonly expressed in terms of the ratio of inputs to outputs as a measure of the efficiency of an operational unit in achieving its objective(s).⁽²⁷⁾

Considerations should also be given here to the effectiveness of operating performance (i.e. the extent to which an operating unit achieves its own objectives in relation to the organisation's objectives - or the relationship of outputs to the desired goals of the corporation).⁽²⁸⁾

This phase of measurement also includes an evaluation of the nature and scope of the deviations and the probing for their causes.

The basis is thus established for such further action as will best serve the organisation's interests. The action here will be corrective to the extent warranted and constructive in a more positive sense when it is

26 Hegazy, A.M. op. cit., p.32.

27 San Miguel, J.G., et al, op. cit., p.6.

28 Idem.

indicated that adjustments or changes in underlying policies or procedures are what are really needed. The appraisal may also indicate that the particular objective itself needs modification and this too will be done as necessary. The governing factor here is surely the profitability of such required adjustments.

Once these adjustments are studied and a decision is made, other problems come to light; of special concern here are:

(a) Who should take the action?

It would seem to be obvious that the best person to take the action required is the responsible supervisor, and, hence, every possible effort should be made to see that the issue is handled in just that way. Nevertheless, there may be situations where the action must actually be taken in some other way.

In such situations, the responsible supervisor will normally alert the lower level supervisor of what is to be done. In other cases, the pressures of time will make it necessary to work through staff personnel. The need in such type of situation is that the staff person carries out his role as the agent of the responsible supervisor, and what needs to be avoided is that actions are taken by persons who are not recognised as legitimate sources of authority.⁽²⁹⁾

29 Brink, V.Z., et al (2), op.cit., p.72.

(b) How the action is taken?

First of all, it is necessary that recipients are given proper understanding of why the action is being taken, thus avoiding the undesirable interpretation that the action is arbitrary in nature.

Secondly, the action needs to be free of emotional characteristics or other kinds of indictments that will generate hostility and resistance. Wherever possible the facts should speak for themselves and action instructions presented in a purely objective and professional manner.⁽³⁰⁾

(c) Problems of continuing evaluation

As indicated earlier, control constitutes a continuous process. The problems of control are, thus, never ending. The previously taken control actions blend into the subsequent recurring control cycles, and a further evaluation of the actions taken adds another input to the effectiveness of the next control cycle. This calls for providing adequate means for feedback. The feedback process is made possible in part by establishing the proper climate for free expression. It also made more effective by specific programmes of inquiry and evaluation. In some other cases, special types of reporting need to be utilised too.

(d) Implementation of Line and Staff Relationships

Traditionally, particular assignments of managerial responsibility have been viewed as either line or staff in basic character. The former type of assignment is considered to fix the responsibility for the final

30 Ibid., p.73.

achievement of the organisation's objectives. The staff group on the other hand is viewed as supporting the line group to do its job. It provides this support through advice and counsel at various levels, through providing service, or by providing needed control for line managers at higher levels over both line and staff operations at lower levels. In more recent times the distinction between the two types of activities has become somewhat blurred, and many students of organisation feel that the two types of activity are now so closely interrelated as to make the distinctions relatively meaningless.⁽³¹⁾

Nevertheless, in most situations the line responsibility continues to exist in a meaningful sense as identifying the managers who must ultimately integrate all dimensions of operational activities and take the responsibility for the final results.

A major type of design problem in connection with line and staff is how much staff support needs to be provided, and where in the organisational hierarchy it should be placed. Also, the implementation phase of line and staff represents one of the most delicate relationships and one which requires both a proper attitude and special skill on the part of both the staff advisor and the line operator. Most studies have, however, indicated that the greatest burden is with the staff advisor because

31 McFarland, D.E. (1), op. cit., pp.412-416. See also: Terry, R.G., op. cit., p.350.

that role can so easily be misunderstood and the potential power misused.⁽³²⁾ The problem, therefore, is for him to recognise that the line manager has both the final responsibility for results and normally a great deal of valuable experience. The need, then, is to see the total problem objectively and to accept a partnership relationship with the line manager out of which the line manager will normally receive the major credit.⁽³³⁾

The line manager at the same time has his responsibilities. He must recognise that he needs all possible help in carrying out his job and that the staff manager can have important contributions to make respecting the solution of the operational problems. He needs, therefore, to have an open and receptive attitude toward the studies and recommendations of the staff counsellor. This does not mean that he is bound to accept those recommendations. But it does mean that he ought to have good reasons for rejecting them.⁽³⁴⁾ In all cases he must be looking for the best possible answers and then it is his right and responsibility to make the final decision. He has the right because he and only he must take final responsibility for the results.⁽³⁵⁾

32 McFarland, D.E. (2), "Conflict and Cooperation in Personnel Administration", (New York: American Foundation for Management Research, American Management Association, 1962) - See also: Toussaint, M., "Line-Staff Conflict - its Causes and Cure", (Personnel, 39, May/June 1962), p.8-20.

33 Mints, F.E., op. cit., pp.82-86.

34 Terry, R.G., op. cit., p.354.

35 Brink, V.Z., et al (2), op, cit., p.88.

Conclusion

As we have seen, a major part of the management process has to do with control. Hence, every manager has an important responsibility to develop a programme of control which will most effectively shape the kinds of performance of which he is in charge. This control programme consists of the overall control effort covering the activities for which he is responsible, and the individual control efforts which together comprise the total control effort.

The internal auditor is committed to organisation service. His special capability in the control function provides an essential entry to the various operational areas which then in turn opens up the opportunity to observe and appraise all aspects of those operational areas. The foundation is thus laid for a range of greater service at all management levels as a means of furthering his objective of organisation service.

(9) Summary of technical terms used in the study

Objectives: The words mission, purpose, goal, and objective appear to be used interchangeably, with little attempt to differentiate their meanings. Yet, McFarland pointed out that the word 'mission' provides a general term to describe the company's overall reason for existence. The mission expresses the objective of the entire enterprise, and is based on top management's knowledge of broad economic needs and the competitive resources of the firm.⁽³⁶⁾ Gross

36 McFarland, D.E. (1), op. cit., p.170.

does not include missions in his array of definitions, but he ranks purpose, objective, and goal in order of increasing specificity. He regards 'purpose' as an all-inclusive term referring to any commitments to desired future situations. An 'objective' is a specific category of purpose that includes the attainment by an organisation of certain states or conditions, such as the satisfaction of the interests of organisation members, the production of goods and services, efficiency, mobilization of resources, rationality, the observance of codes or disciplined behaviour, and the like. A 'goal' is even more specific than an 'objective' or 'purpose' - an objective expressed in terms of one or more specific goals, such as the quantity or quality of production, or costs per unit of output.⁽³⁷⁾

Functions: This term refers to activities by the performance of which it is proposed to attain desired objectives. Such functions may be grouped into three main categories: first, technical, that is, those that are concerned with producing, distributing, financing, etc.; second, the human, that is, those concerned with procuring, developing, maintaining and utilising personnel; and third, managerial, that is, those concerned with planning, organising, directing, and controlling the first two categories. With respect to objectives, the purpose for which the functions are performed are generally referred

37 Gross, B.M., "Organisations and Their Managing", (New York: The Free Press, 1968), p.292.

to as objective. Thus, objectives determine what functions must be performed, yet objective can only be attained through functions. (38)

Policies: policies are guides to the actions or decisions of people in an organisation. They are the planned expressions of the company's official attitudes toward the range of behaviour within which it will permit or desire its employees to act. (39) In relation to objectives, policies express the means by which the company's selected objectives are to be achieved.

Procedures: This term refers to the breakdown of functions and the people who perform them into an orderly sequence of steps with assigned responsibilities. A procedure may be simply defined as an arrangement of functions intended to achieve some objectives. In connection with policies, procedures are a reflection of policy and are often the basis for observing any unstated policies which may exist. Procedures are always subordinate to policy, and policy making is a superior order of activity in executive responsibility. Those who are engaged in procedural tasks must work within the framework established by those who are setting policy. Policies, then, are guides to action, originated by higher management levels who anticipate that recurring questions frequently can be dealt with in advance without specific handling of individual cases.

38 Jucius, Dietzer, and Schlender, "Elements of Managerial Action", (Illinois: Irwin, Inc., 1973), Chapter one.

39 McFarland, D.E. (1), op. cit., p.213.

Organisation structure: This term refers to the pattern or network of relationships between the various positions and the position-holders.⁽⁴⁰⁾ It provides the invisible framework that ties together various technical and managerial experts and specialists.⁽⁴¹⁾ Organisation structures can take many forms, but one of the most common is that of the hierarchical model which consists of a vertical dimension of differentiated levels of authority and responsibility, and a horizontal dimension of differentiated units such as departments, branches, or divisions. This two-dimensional view of organisations is the one depicted by organisation charts showing the positions, departments, and levels within the company - see: Figure (1) in this Appendix.

Levels of Organisation: see (4) in this Appendix.

Accounting and Financial Areas: These areas refer to the basic accounting and financial control activities and which would normally be attached to the finance function within an organisation; hence, accounting and financial data indicates data included in accounting and financial statements of the organisation.

Non-accounting and Non-Financial 'operational' Areas: Refer to all line and staff operations of the concern where the fundamental activity does not directly pertain to the basic financial control activities and which would normally be the types of operations that are not under the direct

40 Ibid., p.337

41 Jucius, et al, op. cit., p.95.

supervision of the finance function within an organisation; hence, non-accounting and non-financial data indicates data not included in the accounting and financial statements of the organisation.

Audit work: This term refers to all internal audit's involvements with reviews of management control systems (i.e. where the internal auditor acts as reviewer of the system).

Non-audit work: That is work which is a necessary part of the accounting system and/or the internal check system employed in the organisation. This is when the auditor may be required to act not as a reviewer of control or check procedures but as the person who actually conducts the control or check.

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- A primary source of information for this research was personal interviews with internal audit managers and other management staff in the organisations participating in the study. No names of individuals interviewed are revealed.