

**CHAPTER 4  
ASSURANCE AND  
CONSULTING SERVICES**

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This guidance fits into the Framework under the heading *Development and Practice Aids*.

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## I. Introduction

Internal auditing provides a variety of services to the organization. These services may range from conducting financial, performance, compliance, system security, and due diligence audits, to participating on committees to select new accounting software, to revising the organization's code of conduct, to teaching training courses in internal control to new managers. If one were to limit one's thinking about internal auditing to just the traditional auditing of internal controls, one would be missing a significant part of the work being performed by the internal audit function in many organizations. In this section we look at internal audit from a much broader perspective than that used in traditional audit research where auditing is treated primarily as a matter of attesting to management's assertions.

We begin with the question of how the internal audit function adds value to the organization. Next we describe the range of value-added internal audit services and examine the nature of assurance and consulting activities. Four specific issues in providing assurance services are then discussed:

- Levels of assurance
- The relation of evidence to type and level of assurance
- Providing assurance outside the organization
- The nature of assurance in fraud investigation

Consulting services also has a number of issues with which practice struggles. We will discuss four of particular concern:

- Blended engagements
- Balancing assurance and consulting
- Limits on the extent of consulting an internal audit function should undertake
- The risk and reward of providing consulting services

Throughout our examination of each of these topics, potential research questions will be identified. These questions are summarized in an appendix at the end of this chapter.

## II. Adding Value

How does one determine if an activity adds value? To begin to answer that question one must first identify the activity's customer. As Exhibit 4-1 illustrates, in the case of internal auditing, the identification of a single or even a primary customer is not clear. Is it the CEO?

Throughout the 1970s and 1980s, writers such as Larry Sawyer (1973) took this position with their view of the internal audit function being “the eyes and ears of management.” Is it the audit committee? Those seeking to solve the problems of organizational governance would argue that internal audit should rather be “the eyes and ears of the audit committee.” Others argue that it is the auditee or operating management that is the customer and that the value the internal audit function adds is in its ability to improve the efficiency and effectiveness of operations. Such is the thinking of those who would evaluate the internal audit function on projected cost savings and improvements. Is it the external auditor? There were those companies in the late 1970s and early 1980s where the *raison d’être* of the internal audit function was to reduce the external audit fee. In fact, today most practicing internal auditors would acknowledge the demands from each of these customers and that somehow the internal audit function must balance its work to meet their needs.

**Exhibit 4-1**  
**Internal Audit Customers**

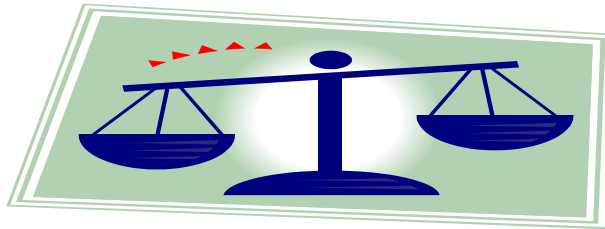


Not only does the internal audit function have a variety of customers, what adds value (the value proposition) for that customer will also vary. Appendix F of the report of The IIA's Guidance Task Force (IIA, 1999, 79-81) provides an initial analysis of the internal audit function's customers and the products these customers value. For example, operating line managers (often the auditee) are interested in the ways internal audit can improve the efficiency and effectiveness of their operations. The external auditor looks to internal audit as an additional internal control which, if operating effectively, can reduce the extent of the work the external auditor must perform to issue an opinion on the organization's financial statements. Suppliers and customers are looking to internal audit to provide assurance on the reliability and security of the information in the systems forming the interface between them and the organization. The line staff of auditees are looking for internal audit to bring them innovations and best practices from across the organization. These various value propositions not only vary but often can be in conflict in terms of allocation of audit resources and, in some cases, tasks.

The tension created from these various customers and their differing demands is best illustrated by considering the audit function's two extreme customers — operating managers and the audit committee. Operating managers are focused on how they can meet their operating objectives. For them the audit adds value by identifying opportunities for improving their operations by either increasing effectiveness or, more commonly, identifying potential cost savings and making operations more efficient. They focus on the recommendations made in the report or suggested during the audit. They are less concerned with the auditor's views or opinions on the adequacy of their internal controls other than the effect reporting such opinions has on their superior's evaluation. The audit committee (board of directors), on the other hand, has relatively little interest in recommendations to improve efficiency. They are concerned with the opinion of the auditor regarding whether internal controls are adequate, the data being provided by managers is reliable, laws and regulations are being followed, and assets are safeguarded. If we think in terms of the traditional scope of internal audit work as presented in The IIA's *Standards for the Professional Practice of Internal Auditing (Standards)*, we see in Exhibit 4-2 that the value comes from different "audit" objectives. In the current terminology of the "new" internal audit definition, this is a distinction between assurance services and consulting services.

Can these customer demands be met with a single product? Until the 1990s internal audit attempted to do so through the traditional operational audit. The assurance was provided in the "opinion" on the adequacy of internal controls or through the implied opinion that controls were adequate through the disclosure of any significant control issues. The consulting side was addressed through the recommendations targeted to the auditee. Attempting to serve both demands through a single product, however, has its limitations. The inherent tension

**Exhibit 4-2**  
**What the Customers Value by Scope of Work**



Audit Committee/Board

- Safeguarding Assets
- Compliance with Laws and Regulations
- Reliability of Data

Value: Improve quality of Information

Operating Management

- Effectiveness and Efficiency of Operations

Value: Agent of change

between these two demands can be seen in the many variations found in audit practice. One underlying theme in the internal audit literature that reflects this tension is the issue of whether an internal audit report should have an overall audit opinion. There has been no requirement for one either in the prior version of the *Standards* or in the current version. Practice varies with strong advocates both for and against. Likewise, must an audit result in recommendations? The *Standards* do not require that it do so.

The literature has basically presented recommendations as a marketing tool for audit, a means for getting auditees to address control issues by presenting them with a practical option. With the pressure in the late 1980s and early 1990s for every part of the organization to demonstrate its ability to add value, the single product approach begins to be challenged. We saw many audit functions expanding “products” through activities such as control self-assessment, involvement in quality and re-engineering initiatives, and implementation of enterprise risk management systems. Currently, a growing number of audit functions are taking a multi-product approach. For example the audit function of FirstEnergy Corp. offers its customers 21 distinct services ranging from investigation into alleged fraud, to surveying customers to determine satisfaction, to facilitation of groups to arrive at process improvements as well as the traditional audit (Roth, 2002, pp.168-169).

Given the various different demands from different customers, how in a world of limited resources does the internal audit function balance the services provided to meet these various customers' needs? This is the fundamental question of internal audit management — one which current events have brought to the forefront of the profession. But before we can address the issue of balancing these various customer needs, we must first answer the question, “Is there an ultimate customer?” In other words, are all of internal audit's customers and their needs equally important? And, if not, who is the ultimate customer of internal audit?

Currently, there does not seem to be agreement on the answer to the questions of the ultimate customer in the profession and, in fact, it is a question rarely directly discussed or addressed. It is not a question practicing audit directors are comfortable talking about because of the delicate balance a director must maintain among these various groups. In the days of Sawyer things were simple — “audit was the eyes and ears of management” — and the term “management” meant the upper management of the organization, the people who hired auditors and determined if they got a raise. Life was simple for the audit director — keep the CEO (or CFO where often internal audit reported) happy and you were doing the job. In the words of the *Statement of Responsibilities of Internal Auditing*, “the objective of internal auditing is to assist all members of management in the effective discharge of their responsibility by furnishing them with analyses, appraisals, recommendations, and pertinent comments concerning the activities reviewed” (as found in Sawyer, 1973, p. 513).

While in many sectors and regions of the world this “eyes and ears of management” is still the predominate approach, attempts to solve organizational governance problems have shifted the internal audit to also become “the eyes and ears of the audit committee.” For example, the report from the Joint Committee on Corporate Governance (2001) in Canada envisions a strong role of the internal audit function in assisting the audit committee in fulfilling its role:

There are many operational aspects of the audit committee's relationship with the internal audit function that are important for the effective oversight of the internal control framework and culture. Where a corporation has an internal audit function, the audit committee should approve its mandate, be satisfied that it has adequate resources to perform its responsibilities, and ensure that the director of internal audit has direct and open communication with the committee....Where internal audit does not exist, the audit committee has an important oversight role that goes beyond the normal operational issues. (2001, p. 31)

A similar view is found in the United Kingdom:

Senior management and the board may desire objective assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent

where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice....In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control is functioning as intended. In these circumstances, the board will need to assess whether such processes provide sufficient and objective assurance....The board of a company that does not have an internal audit function should assess the need for such a function annually having regard to the factors referred to in paragraphs 43 and 45 above. Where there is an internal audit function, the board should annually review its scope of work, authority and resources, again having regard to those factors....If the company does not have an internal audit function and the board has not reviewed the need for one, the Listing Rules require the board to disclose these facts. (Internal Control Working Party of the Institute of Chartered Accountants in England & Wales, 1999, paragraphs 43 to 47)

Even in the governmental sector the internal audit function (as distinct from the legislative and external audit functions) is being called upon to serve the audit committee, as well as management. The IFAC Public Sector Committee has explicitly stated that to be fully effective, the audit committee is independent of the organization's executive management. To achieve independence necessary for effectiveness one of the requirements is that:

The chief internal auditor and the external auditors bring all significant findings arising from audit activities to the attention of the audit committee, and if necessary, the governing body (IFAC, 2001, paragraph 7.254).

Further, in the light of the recent highly visible cases of corporate governance failure both in the United States and elsewhere, The Institute of Internal Auditors has recommended to the Congress of the United States that "All public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee" (IIA, *Recommendations...*, 2002).

But can the internal audit function serve two masters? Can it provide the objective assurance required of the audit committee and senior management and provide the partnering with operating management necessary to bring about operational improvements? Is the delivery of assurance services compatible with delivery of consulting services? As the internal auditing profession entered the 21<sup>st</sup> century there seemed to be consensus that these two roles were compatible and that both masters could be served. However, the same failures in corporate governance that pushed The IIA to call for direct reporting to the audit committee has called into question this compatibility. An article on the front page of *The Wall Street Journal* dramatically illustrates the shift in thinking on the compatibility of assurance and consulting



(Dugan, Berman, and Barrionuevo, 2002). The article describes the transcription from a video prepared by Arthur Andersen to tout the integrated audit approach that had developed at Enron. As we see from some sample comments in Exhibit 4-3, what once was a positive statement has now become negative. Perhaps one of the most telling is the statement by Mr. Buy, Enron's chief risk officer, who said in a transcript that the energy company wouldn't have developed as rapidly without Andersen, partly because the firm helped deal with the Enron board:

"We move fast around here, things cook. I mean, it's a high-stress, high-pressure fast-moving place. ... You don't want anyone at [risk-control meetings] that's going to slow you down or bog you down or not be value added, so it's good to have the Arthur Andersen people who are, you know, I think they're smart, they're quick, they understand what we're doing ... " But Mr. Buy said some members of the Enron board's audit committee "don't know the details of [the] trading business, they don't know about value at risk ... . The board is also relying equally as heavily on Andersen, who attends the same meetings and they have a presentation, I have a presentation. If we're adrift, one of those two groups has got to let them know."

While this was a case of external audit and consulting services, the potential parallel with assurance and consulting in internal audit certainly raises concern.

#### **Exhibit 4-3**

**Source:** Front page of the April 15, 2002, issue of *The Wall Street Journal*

##### **In Their Own Words**

Excerpts from transcripts of Arthur Andersen videotapes on the accounting firm's relationship with Enron.

*"Over time we and Arthur Andersen will probably mesh our systems and processes even more so that they are more seamless between the two organizations."*

— **Jeffrey Skilling**, then Enron president

*"Arthur Andersen's penetration or involvement in the company is probably different than anything I've experienced in that they are kind of everywhere and in everything."*

— **Richard Buy**, then Enron's chief risk officer

*"Out here we don't call audit audit."*

— **Patricia Grutzmacher**, Andersen auditor

Clearly one of the major challenges facing the internal auditing profession will be positioning of itself in terms of providing assurance and consulting services. What will be the effects on the mix of services if The IIA-recommended shift to direct reporting to the audit committee takes place? Will such a shift hinder internal audit's ability to add value to the organization? Will it increase tension between auditor and auditee? Will it have a chilling effect on the internal audit function's relationship with senior management? To be able to approach issues such as these, a clear understanding of the essential nature of assurance and consulting services is needed.

### **Research Questions**

- What are the various value chains through which internal audit adds value to its customers?
- How do characteristics of the organization such as industry, size, regulatory environment, and organizational structure change the potential to add value through these various value chains?
- What are the mechanisms used by internal audit management to balance the demands of the various internal audit customers?
- Is the multi-product approach more effective in meeting customer demands than the traditional single product (the traditional internal audit) approach?
- What organizational factors (if any) must be in place for the multi-product approach to be successful?
- Is the traditional internal audit an effective way of meeting the demands of operational managers (the demand for consulting services)?
- Is there a primary (ultimate) internal audit customer? If so, who is it?
- Does this ultimate customer depend on any organizational or environmental characteristics?
- What will be the effects on the mix of services if The IIA-recommended shift to direct reporting to the audit committee takes place?

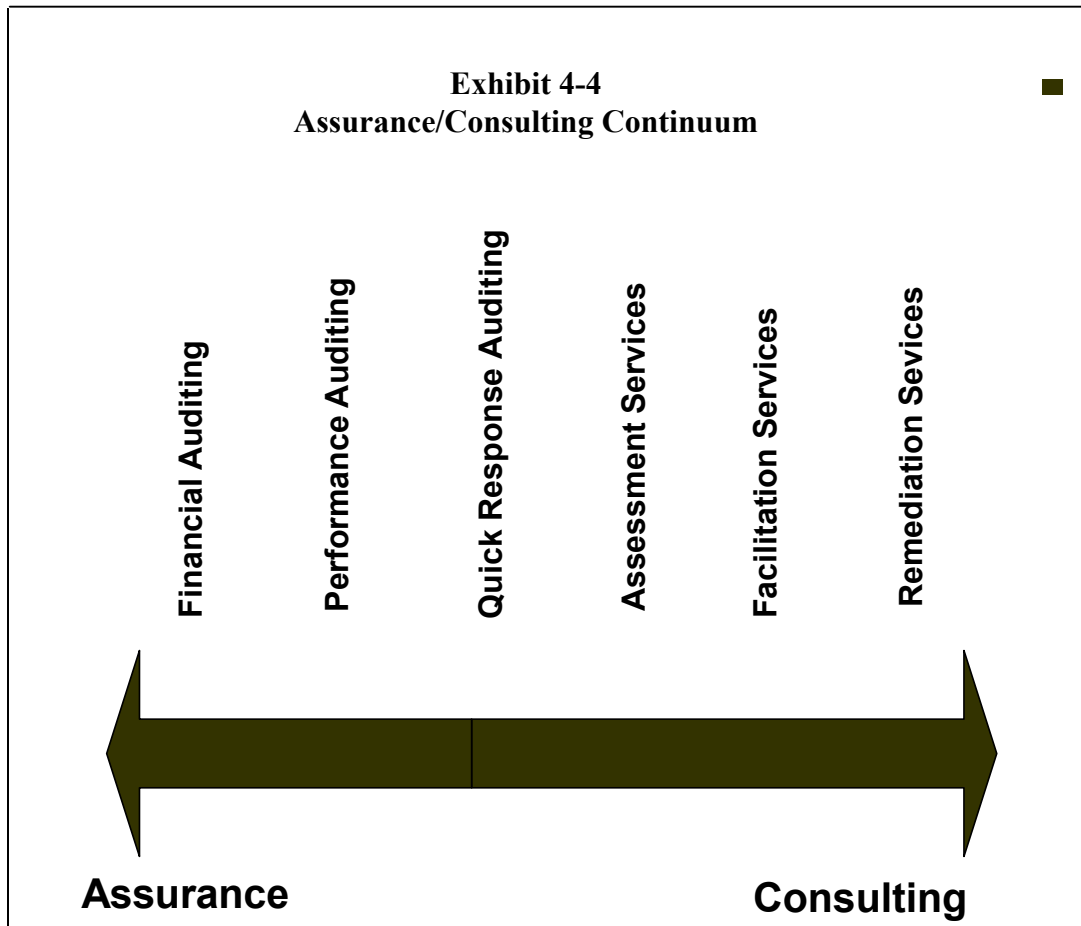
- Will a shift to direct reporting hinder internal audit's ability to add value to the organization? Will a shift to direct reporting increase tension between auditor and auditee?
- Will a shift to direct reporting have a chilling effect on the internal audit function's relationship with senior management?

### **III. The Assurance/Consulting Continuum**

Internal auditing is defined as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. Assurance activities certainly include the traditional internal audit, but also include other services. The glossary to the *Standards* defines an assurance engagement as an objective examination of evidence for the purpose of providing an independent assessment on risk management, control, or governance processes for the organization. Examples of the types of engagements that would be considered assurance engagements include financial, performance, compliance, system security, and due diligence audits.

The glossary defines consulting activities as advisory and related client service activities, the nature and scope of which are agreed upon with the client and which are intended to add value and improve an organization's operations. Consulting activities, though new to the definition and the Professional Standards, include activities that have long been performed as part of the internal audit function's work. This includes such activities as conducting internal control training, providing advice to management about the control concerns in new systems, drafting policies, and participating in quality teams.

Exhibit 4-4 shows a continuum of six basic types of internal audit services: financial auditing, performance auditing, quick response auditing, assessment services, facilitation services, and remediation services. The taxonomy comes from a model developed by the Government Audit Training Institute, the Graduate School, the United States Department of Agriculture, and underlies the assurance and consulting implementation standards of the current IIA *Standards*. The three audit services are assurance activities and the assessment, facilitation, and remediation the consulting activities. The extreme left of the continuum represents traditional financial attestation audit and, as one moves to the right, goes from traditional attestation (pure assurance) to operational auditing to fraud investigation, then into consulting with activities such as control self-assessment to the extreme of remediation services where the internal audit function is doing the actual work of client management rather than providing assurance.



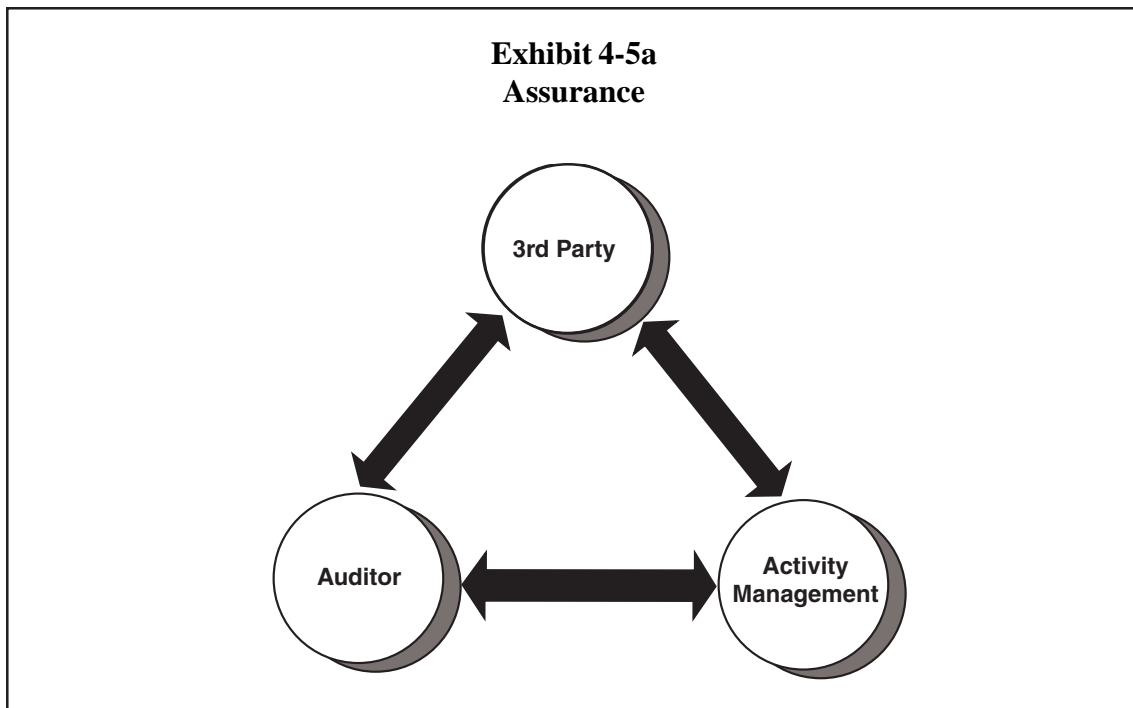
While the taxonomy of the assurance consulting continuum captures the extent of departure of from the traditional attestation paradigm, it does not delineate the distinction between assurance and consulting. There is, however, at least one fundamental distinction between the two types of services, a distinction that is critical to understanding the potential for their incompatibility.

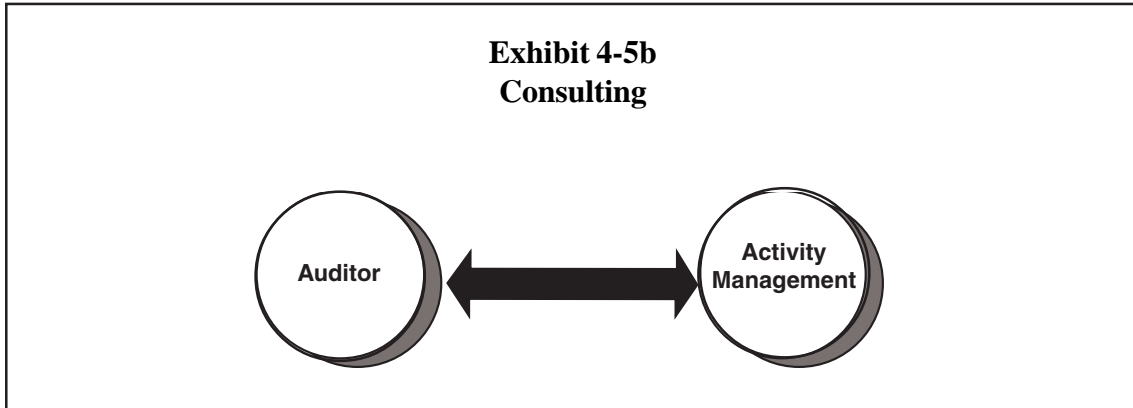
The nature of the distinction involves the number of parties involved in the engagement contract and is illustrated in exhibits 4-5a and 4-5b. Going back to the model of the traditional financial statement audit found in ASOBAC we find auditing defined as:

... a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of

correspondence between those assertions and established criteria and communicating the results to interested users. (American Accounting Association, 1973)

While this definition proved not to be sufficiently broad to extend to assurance services, it did capture several essential elements of the assurance activities. First, assurance engagements involve a systematic process of objectively obtaining and evaluating evidence. Second, these engagements require the existence of established criteria. Third, the engagement involves the communication of the results to interested users, some third party apart from the provider of the service or those involved in the process or area under review. It is this third party that is the customer in the audit and assurance process, and who determines the value of the activity. As a result, the interest of this third party must be protected throughout the engagement in order for the engagement to be effective, which significantly complicates the process of providing auditing and assurance services. Making matters even more difficult, the third party is usually not present or involved in establishing the engagement contract, regardless of whether the contract is explicit or implicit. Further, in the case of the traditional external audit, the third parties are for the most part unknowable other than by general type (for example, creditors, potential investors, shareholders, etc.).





Auditing and assurance standards are the primary mechanisms that have developed to protect the interests of the third party and that allow for efficient engagement contracting for assurance services. One example of how such protection is embodied in the standards are requirements that the auditor be free to set the scope of work rather than have the scope of work set by activity management of the area under review. Other examples would be rules on auditor objectivity and independence and requirements regarding form and content of communications. The extent of these would also seem to vary with the distance of the third party from the contract and whether or not specific third parties are known. Thus, external audit appears to require more extensive standards than internal audit. And external assurance engagements with known third parties appear to need less extensive standards than traditional external audit.

Consulting in contrast involves only two parties, the auditor (service provider) and the activity management. The activity management — the client — is the customer. The value added of the consulting engagement is determined by its value to activity management. There is no absent third party requiring protection, so there is no need for standards stating that the scope of work must be up to the auditor; in consulting services if the client (activity management) does not see the potential value of doing further work in an area the client is free to have the auditor stop. Nor do we have need in standards for specific reporting requirements such as the requirement that there must be a written report or for requirements for follow-up on engagement results. There may be written reports and auditors may do follow-up, but these are determined in the specific engagement contract and at the request, or at least with the agreement, of the client.

Two other distinctions are sometimes made between assurance and consulting activities. First, assurance engagements require an opinion as to the result whereas consulting

engagements produce recommendations if indeed there is any formal reporting involved. Second, assurance engagements are mandatory in the sense that the audit function cannot arbitrarily decide not to undertake an assurance engagement once it has been identified as an area of need. The function may do so if higher risk areas are identified or the preliminary assessment of risk that led to the area being selected proves to be mistaken, but not because the audit staff doesn't want to go to Lubbock or you don't have staff with the needed skills. Consulting engagements, on the other hand, may be declined by the audit function without need of elaborate justification. The absence of staff skills or scheduling issues provides sufficient cause. Whether these two distinctions have significant implications has yet to be formally analyzed in the literature.

### **Research Questions**

- If one views the primary role of professional standards for auditing and assurance as protection of the interest of third parties, what is the minimal requirement for a set of standards and how do they vary with characteristics of the assurance service and of the third party?
- Must an assurance engagement result in the communication of an opinion?
- Are there any non-discretionary consulting engagements?

### **IV. Assurance Services**

The assurance/consulting continuum has three basic types of assurance services. The first is "financial auditing" and includes engagements that follow the traditional attestation model. This would include situations where the internal audit function audited a division's quarterly results or a claim by management that a product line was profitable. Also under this type of service would be compliance attestations such as audits of travel expenditures or conflict of interest policies. This category would also include work done in conjunction with the organization's external auditors for the audit of the financial statements. Models for these types of engagements have been well developed in the extensive literature on external financial statement auditing. However, in internal auditing, particularly in the government sector, there is an increased emphasis on the attest type of engagement with regard to the auditing of broader performance measures. The movement of a significant number of corporations to balance scorecard systems may provide more internal audit functions with similar engagement opportunities. But an analysis of who are the customers of these performance measure audits and how value is added is lacking in the literature, as is empirical study on the extent of such practices.

“Performance auditing” or operational auditing represents the traditional internal audit. Selection of areas for these types of engagements in most current internal audit functions are made through a process of risk assessment with the objective of minimizing the risk with constrained audit resources. While the formal model for this service has not been extensively developed in the academic literature, there exists a large practitioner literature describing how to conduct such engagements. As mentioned earlier, in the past the internal audit function has tried to satisfy all its customers with this performance/operational approach. For the audit committee and senior management, this type of engagement provided assurance on internal controls and in many organizations gave an opinion on their adequacy or even assessed a grade. For the auditee (operating manager) it provided a list of recommendations about how weakness could be corrected or improvements in efficiency made. With a shift to a multiple service approach will there be a change in the performance audit in terms of attempting to address the concerns of operating managers? Proponents of control self-assessment certainly argue that there are more effective ways of achieving process improvements than the traditional performance audit. Would this type of assurance service change if the focus were only to provide assurance and not to improve processes? By such a shift, could significant efficiencies be gained in providing assurance on the adequacy of internal controls?

“Quick response auditing” includes services that typically arise by special request of upper management. In this respect they are like consulting, but are not classed as such because the management requesting them is typically a third party looking for assurance. The dominant engagements of this type are fraud investigations, but also include valuation and due diligence engagements.

### **Research Questions**

- Does auditing performance measures add value? Who are the customers for such attestations? Is the increased adoption of the balanced scorecard approach in the private sector creating a demand for such services?
- Is the traditional performance audit obsolete? Can assurance on internal controls be more effectively and efficiently obtained without the traditional focus on process improvement as well?
- Is fraud investigation an assurance service? Who are the customers and how is value added?



- Are separate implementation standards needed for fraud investigation? Would the adoption of such standards have significant ramifications for challenges in court to investigation results?
- How can the internal audit function demonstrate that the assurance engagements it has performed have added value to the organization?

## **V. Consulting Services**

“Assessment services” are engagements in which the auditor examines or evaluates a past, present, or future aspect of operations and renders information to assist management in making decisions. These engagements need to be as timely as possible and usually don’t include specific recommendations for management. Examples of this type of consulting engagements would be the assessment of controls in a system design, such as assessing the adequacy of internal control in a proposed accounts payable system. Other examples might be: (1) the study and evaluation of the proposed restructure of the organization to reflect the most practical, economical, and logical alignment, or (2) estimating the savings from outsourcing process.

“Facilitation services” are engagements in which the auditor assists management in examining organizational performance for the purpose of promoting change. The auditor does not judge organizational performance in this role. Rather, the auditor guides management in identifying organizational strengths and opportunities for improvement. Such engagements include control self-assessment, benchmarking, business process reengineering support, assistance in developing performance measurement, and strategic planning support.

The final type of consulting service on the assurance/consulting continuum is “remediation services.” This represents the most extreme and threatening type of consulting activity in terms of incompatibility with providing assurance, and yet has always been present to a degree in all internal audit functions. These are engagements in which the auditor assumes a direct role designed to prevent or remediate known or suspected problems on behalf of the client. Such an engagement might be as innocuous as developing and delivering a training seminar on internal controls. Certainly such training is a common and valuable service provided by many internal audit functions for their organizations, yet it is clearly a management function. Or an engagement could involve the drafting of policies for cash handling or writing the organization’s code of conduct. Such activities begin to make auditors nervous about their ability to objectively audit these areas at a later date, but what auditor has not seen the words written in an audit recommendation to illustrate what sort of policy the

auditee might implement a year later word for word in the auditee's policy manual? Finally, in the extreme, such engagements include the augmenting of operating personnel, in which the auditor actually performs operating functions for a period of time or even on a permanent basis.

### **Research Question**

- How do internal audit functions determine which consulting engagements to accept?

## **VI. Issues in Providing Assurance Services**

In providing assurance services there are numerous issues with which practitioners are currently struggling. Some have been issues for many years; others have recently come to the forefront because of changes that advances in technology have brought to business practices. These issues can be categorized into four areas:

- Level of assurance
- The relation of evidence to type and level of assurance
- Providing assurance outside the organization
- The nature of assurance in fraud investigation

Each of these areas offers researchers a challenging set of problems that can be productively approached with a variety of methodologies.

### ***Level of Assurance***

Does each assurance engagement that internal audit conducts provide the same level of assurance? In one sense the *Standards* require that sufficient evidence be collected to support the reported conclusions, but do these conclusions vary in the amount of reliance the user should place in the auditor's work? In the traditional financial attestation audit there is presumed to be, at least in theory, some same minimal level of assurance across audits. It is not clear this same presumption holds for internal audit assurance engagements. Further, financial attestation standards in many parts of the world explicitly recognize the levels of assurance based on the engagement design. For example, in U.S. auditing standards one can have positive assurance, negative or limited assurance, or no assurance based on the engagement design (audit/examination, review, compilation). The U.S. governmental auditing standards have proposed to adopt a similar approach (GAO, 2002c, Chapter 6). Would such distinctions be useful in internal audit? What type of criteria would be necessary to distinguish the levels?

At a more basic level, this raises the fundamental issue of effectiveness of the communication regarding assurance in internal audit reporting. Are the users of the reports attributing the amount of assurance the internal auditor intended to communicate? Do all users interpret this the same way or does it vary as one moves from immediate operations to executive management to the board? Also, as there is little standardization in reporting format, how do factors such as whether or not an explicit opinion is given, the detail of the reporting, the extent that audit procedures are described, the quantification of the impact of findings, etc., influence the degree of assurance the user ascribes to the report?

### ***The Relation of Evidence to Type and Level of Assurance***

Related to the questions of whether internal audit does, or should, communicate degrees of assurance, is the relation of evidence to the type and level of assurance. For instance, do auditors need more evidence if they are providing assurance to the audit committee than to the local operating managers? Do the objectives of the assurance require different amounts of evidence? For example, does assurance on compliance with laws and regulations require more evidence than assurance on the operating efficiency of a production process? Can there even be assurance without detailed testing? What is the impact on evidence requirements of whether the engagement is expected to provide assurance for external reporting (such as CEO certification under Sarbanes-Oxley), assurance to the auditors attesting to the financial statements, or assurance to regulatory auditors?

A significant difficulty in addressing such issues is the lack of theoretic development relating evidence to assurance. While in U.S. financial auditing standards, SAS No. 47 provides a basic framework for the relation of evidence to level of assurance for attestation of financial statement assertions, it has been more difficult to apply this framework beyond the financial audit. SAS No. 68 attempted to extend the framework to compliance attestation, but this risk framework seemed to have lost favor and was not carried through explicitly to SAS No. 74, which subsequently replaced SAS No. 68, nor into the attestation standards other than the occasional footnote (although SSAE No. 10 does make reference to “maintaining attestation risk at an appropriately low level” and provides some definitions as these concepts apply to compliance attestation engagements). In internal audit there has been even less focus paid to the evidence issue so that a systematic look at this issue is long overdue. The current increased demand for overall assurance on the adequacy of internal control and the absence of fraud as a result of the CEO and CFO certification requirements will further increase the need for research on this issue.

### ***Providing Assurance Outside the Organization***

A trend of organizations to form strategic alliances and advancements in technology has led to a significant increase in the interconnectivity of organizations. As these trends continue and e-commerce becomes a fundamental way in which organizations operate, there will be increasing demands for assurances of the quality of computer systems, information security, controls over privacy of data, and quality assurance practices. Increasingly, internal audit functions are being approached to provide assurances to outside organizations on these matters. For example, in the case of alliances, if the security of an organization's information processing is dependent on the security of a potential partner's information processing, both organizations will demand assurance that the prospective partner's information system is secure. If the prospective partners have competent and objective internal audit functions that have audited against a set of criteria acceptable to both parties, the organizations may not feel the need to spend the money required to get external assurance but seek to share the respective internal audit function's work. Or in a case posed to the Internal Auditing Standards Board the question was raised as to whether an internal audit department could provide the equivalent of a SAS 70 review on a bank's computer operations when the bank provides processing services for other banks. Here the other banks requested the control evaluation from the internal audit department because they perceived the report would be more useful than a report from an external auditor.

Such situations give rise to the need for research on a number of issues. Under what conditions can an internal audit function provide assurance to parties outside the organization? Governmental auditing reports routinely provide assurance to outside parties such as the general public or other governmental entities. However, in the private sector this is relatively rare, the exception being audits of joint ventures, the use of reports by external and regulatory auditors, and some rare cases of certification (e.g., attestation to the United States Environmental Protection Agency (EPA) in its oxygenated gasoline program Title 40 CFR Part 80.125). What factors need to be considered by the internal audit function before providing assurance to outside parties? Are their potential liabilities related to providing such assurances? Does the audit committee need to be informed and approval obtained? What if management takes a report and provides it to outside parties to give them assurance on controls when the report and engagement were completed with the intention of only internal use?

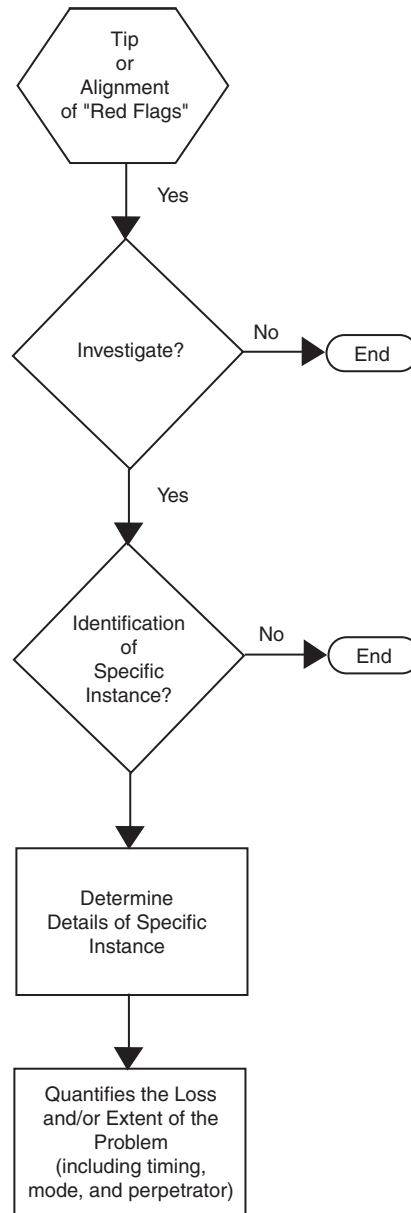
### ***The Nature of Assurance in Fraud Investigation***

Fraud investigation has long been a part of the services provided by internal audit functions. However, it does not fit easily into the attest and assurance framework. First, we must make the distinction between assurances that there is no fraud from fraud investigation. Assurance about the absence of fraud is of course something that most audit customers greatly desire and may well believe that they are getting, but for which financial statement auditors, and subsequently internal auditors, have gone to great lengths to avoid taking responsibility. This seems to be driven primarily to avoid liability problems on the part of financial statement auditors and accountability on the part of internal auditors. However, it may be possible that engagements could be designed to provide at least limited levels of assurance that no fraud is taking place. Such engagements may be very different in structure from the traditional audit, using improved statistical and analytical techniques to continuously monitor processes.

A fraud investigation engagement, on the other hand, arises from some triggering event or cue (a tip or alignment of “red flags”). After the decision to begin an investigation, the objective becomes to find evidence of a specific irregularity. If evidence is found, then details are determined regarding how the specific irregularity occurred (the timing, mode, and possible perpetrators). Then the objective becomes to quantify the extent of the loss and scope of the problem and determine the specific perpetrator. This process is illustrated in Exhibit 4-6 and is distinct from the process followed in other assurance services in that there are several sequential decision points at which the engagement may be terminated.

From a judgment and decision-making perspective there are a number of research questions that could be asked at each step. For instance, both descriptive and normative research into what sort of alignments of “red flags” trigger, or should trigger, the decision to pursue investigation is an area that already has developed a significant body of literature. Yet an equally (and some would argue more) important trigger given the dramatic increase in the use of “hot lines” is tips. How should these allegations be evaluated to determine if investigation is warranted? Are there characteristics of the allegation that influence how the cost of moving to investigation when no fraud is occurring should be balanced with the cost of not investigating when there is fraud? This is a decision that on any given day a significant portion of the population of internal auditors and compliance officers face, yet has been relatively unexplored by researchers (Anderson, 1995). Similarly in the next step in the process, as well as in the remaining steps, there are a number of questions that could be asked about the decision and judgment processes involved. For instance, what factors influence the decision to stop the investigation and conclude that no irregularities occurred?

**Exhibit 4-6**  
**The Fraud Investigation Process**



In addition to the research questions surrounding the various decisions and judgments involved in the investigation process, what sort of assurance (if any) is actually provided by an investigation? Further, assuming some degree of assurance is provided through the investigation, is the level of assurance symmetrically related to the outcome (fraud found versus cases where no fraud is found)? Also, an issue for investigation is whether there should be standards of practice regarding how such investigations are conducted. The interesting aspect of this question is why have there been no standards developed for investigation when there is such a proliferation of standards for other assurance services? What is unique about the environment and process of fraud investigation that explains this lack of demand for standards?

### **Research Questions**

- Do all engagements provide the same level of assurance? Is there a need for different levels?
- Does the amount of assurance attributed to a report vary as one moves from the operating level to executive management to the board?
- What factors in the structure of the report (presence of an opinion, length of report, quantification of findings, etc.) impact the user's attribution of assurance?
- What is the relation of evidence requirements to the type and level of assurance being provided?
- Should internal audit provide assurance to parties outside the organization? What are the risk and rewards of doing so?
- Can audit engagements be designed to provide at least some level of assurance that no fraud exists in an area?
- What sort of alignments of "red flags" trigger, or should trigger, the decision to pursue investigation?
- How should allegations of fraud be evaluated to determine if investigation is warranted?
- Are there characteristics of the allegation that influence how the cost of moving to investigation when no fraud is occurring should be balanced with the cost of not investigating when there is fraud?

- What sort of assurance (if any) is actually provided by a fraud investigation? Assuming some degree of assurance is provided through the investigation, is the level of assurance symmetric relative to the outcome (no fraud found versus fraud found)?
- Should there be standards of practice regarding how investigations are conducted? Why have there been no standards developed for investigation when there is such a proliferation of standards for other assurance services? What is unique about the environment and process of fraud investigation that explains this lack of demand for standards?

## **VII. Issues in Providing Consulting Services**

The explicit consideration of the internal auditing function's provision of consulting services has evolved relatively recently and thus there is a significant need for research. In addition to the basic need for clarification of concepts and the fundamental questions addressed above, there are four other issues that are of particular relevance to practice:

- Blended engagements
- Balancing assurance and consulting
- Crossing the limits — are there bounds on the extent of consulting a function should do?
- The risk and rewards of providing consulting services

### ***Blended Engagements***

With the explicit recognition of consulting in the new definition of internal auditing and the development of distinct implementation standards for each, the question arises as to whether engagements can be structured to combine both assurance and consulting services. An example of such a potential engagement would be if one were undertaking an audit to evaluate the internal controls in a division that was selected based on the organizational-wide risk assessment. During the opening conference, the divisional manager asks the engagement team to extend its work and look at how the division could improve the efficiency of their order entry and tracking system and report the results back to her. The assurance engagement team and chief audit executive agree to look at the order entry and tracking system as well. How should this engagement be handled? Should the assurance team construct a separate engagement letter? What if, during the work on the tracking system, the team identifies several potential weaknesses in the controls, tells the manager, and she says to discontinue work, that she will take care of the weakness and then come back to the efficiency concerns later? Does the team continue to look at the control issues in the tracking



system? Do they include the weaknesses in their assurance report? Which set of standards should they look to for guidance? Is the converse the same — can a consulting engagement be extended into an assurance?

### ***Balancing Assurance and Consulting***

Over the past 20 years internal audit practice has made significant advances in risk assessment and the ability to systematically allocate audit resources to minimize residual risk. However, these risk assessment mechanisms allow systematic allocation over resources dedicated only to assurance services; they do not provide a mechanism for determining how to allocate resources between potential assurance and consulting engagements to maximize the audit function's value to the organization.

While a systematic mechanism has not been developed, chief audit executives (CAEs)<sup>1</sup> are daily facing this resource allocation problem. How are they making these decisions? The current environment offers a unique opportunity to study the factors influencing these decisions as in 2002 we have seen in the U.S. a dramatic change in the audit environment and a rapid radical shifting of demand for audit services among internal audit customers from consulting to assurance. Is this shift consistent across industries or is it more rapid in some industries than others? What other factors such as size, audit committee characteristics, ownership concentration, etc., affect this shift? Further, this change has occurred not just in the private sector, but also in governmental auditing with the revision of the independence standards by the GAO. Opportunities exist in this sector to construct studies that take advantage of comparisons in the ratio of resources allocated to assurance versus consulting across the various levels of government within the U.S. and, potentially more interesting, comparisons across countries.

Are there limits to how far an internal audit function can go in determining the balance? A case could be made for an audit function to allocate essentially all its resources to assurance activities and do no consulting, but could the opposite case be made? Could you have a “no assurance” internal audit function? It would seem a contradiction, yet there have been internal audit functions which have shifted their activities to the point where they are doing essentially no traditional audit work. In an article by Hawkins and Huckaby (1998), the authors describe how Arkansas Blue Cross and Blue Shield used a combination of control self-assessment and management certification to provide a basis for the CEO and CFO attestation of the control structure over financial reporting per COSO, and the subsequent issuance by the external auditor of a COSO attestation letter to the audit committee. In this process the internal audit function's key role is in training managers in risk assessment and

facilitating the self-assessment process, the actual assurance is obtained from the external auditor who tests a sample of the management certifications. A similar process of obtaining assurance over compliance is described in Crawford, Chaffin, and Scarborough (Chapters 1 and 6, 2001). Both of these examples build from the COSO framework with management at each level actually implementing the internal control framework of setting objectives and goals, assessing risk, designing control, implementing controls, and monitoring. The internal control process is then taken a step further with the certification process. The auditor's role in assurance, though critical, is minimal, being reduced to testing a sample of the certifications. However, the consulting activity involved in this approach is very high in terms of supporting the self-assessment and certification processes.

The self-assessment/certification strategy of providing assurance seems to be potentially very powerful and certainly offers an attractive potential for providing assurance on the internal controls to boards and external parties. It also raises a number of research opportunities. A rigorous analytical modeling of these processes could provide needed insights. Systematic testing of the strategies' effectiveness is also needed.

### ***Crossing the Limits***

Referring back to the Internal Audit Activity Continuum in Exhibit 4-4, is there a limit to how far an audit function should go on the consulting end? In particular, are remediation services incompatible with providing assurance services? The GAO's recent independence standards lay out a set of basic principles and seven safeguards that significantly restrict consulting activity for governmental auditors, and subsequent interpretations have set some further specific limits (GAO 2002a and 2002b). Although most remediation services are considered incompatible with auditor independence, some activities in this category are not (e.g., training). While these types of restrictions create significant issues for traditional governmental internal audit departments, outsource providers of government internal audit services are even more challenged in meeting these requirements. Audit committees in the private sector appear to be following along this trend as well.

In addition to independence and objectivity considerations, there may be other reasons for internal audit functions to limit the extent of their consulting activities. While there are many possible consulting services that internal audit could provide, it is not clear that internal audit has a competitive advantage in all areas. Should internal audit limit its consulting activities to its defined domain of risk management, control, and governance processes? Why do internal audit functions undertake consulting services outside their defined domain?

### ***The Risks and Rewards of Providing Consulting Services***

Finally, what are the risks and rewards of internal audit providing consulting services? Antidotal evidence suggests that potential risks include internal auditor loss of objectivity, damage to the function's reputation when consulting projects fail, not meeting assurance responsibility, negative political exposure, and cost and time overruns. However, a systematic examination is needed to identify what are the risks to the audit function in undertaking consulting services, what particular factors can lead to failure, and what policies and procedures need to be put into place for the function to manage these risks. Similarly, on the reward side, providing consulting services offers the promise of added value to the organization, improved internal audit relations with operating management, greater exposure for staff, and enhanced career opportunities for staff. Systematic study is needed to see if such rewards are realized and how they can be measured.

### **Research Questions**

- Can consulting engagements be structured to provide assurance?
- Can a mechanism be developed to allow internal audit functions to systematically allocate resources between assurance and consulting to maximize internal audit's value to its organizations? How do changing customer demands influence the balance between assurance and consulting services?
- Can an internal audit function only provide consulting services?
- Are there consulting services that internal audit should not provide?
- What are the risks for the internal audit function in providing consulting services and how can they be managed?
- What are the rewards of providing consulting services and how can they be measured?

## **VIII. Summary**

In striving to add value to the organization, internal auditing provides a variety of different services to a number of types of customers — each type with its own distinct needs. Past research has focused on a relatively narrow range of this service spectrum, for the most part investigating internal audit's role in providing assurance on internal control, thus there is a significant opportunity for researchers to examine these other services. In this chapter, we also considered two of the audit function's most extreme customers — the audit committee and operational managers — and discussed how their demands on the internal audit function not only differed in how value is added, but are in potential conflict. Research could significantly improve our understanding of how internal audit functions currently manage to trade off these conflicting customer demands and potentially provide significant improvement in practice through the development of mechanisms for optimizing resource allocation across the service spectrum. Additional research questions were identified in the discussion of current issues in providing assurance and consulting services. The appendix to this chapter provides a summary of these research questions identified.

## **IX. Appendix I: Chapter Research Questions**

### **Adding Value**

- What are the various value chains through which internal audit adds value to its customers?
- How do characteristics of the organization such as industry, size, regulatory environment, and organizational structure change the potential to add value through these various value chains?
- What are the mechanisms used by internal audit management to balance the demands of the various internal audit customers?
- Is the multi-product approach more effective in meeting customer demands than the traditional single product (the traditional internal audit) approach? What organizational factors (if any) must be in place for the multi-product approach to be successful?
- Is the traditional internal audit an effective way of meeting the demands of operational managers (the demand for consulting services)?
- Is there a primary (ultimate) internal audit customer? If so, who is it? Does this ultimate customer depend on any organizational or environmental characteristics?
- What will be the effects on the mix of services if The IIA-recommended shift to direct reporting to the audit committee takes place? Will such a shift hinder internal audit's ability to add value to the organization? Will it increase tension between auditor and auditee? Will it have a chilling effect on the internal audit function's relationship with senior management?

### **The Assurance/Consulting Continuum**

- If one views the primary role of professional standards for auditing and assurance as protection of the interest of third parties, what is the minimal requirement for a set of standards and how do they vary with characteristics of the assurance service and of the third party?
- Must an assurance engagement result in the communication of an opinion?
- Are there any non-discretionary consulting engagements?

### **Assurance Services**

- Does auditing performance measures add value? Who are the customers for such attestations? Is the increased adoption of the balanced scorecard approach in the private sector creating a demand for such services?
- Is the traditional performance audit obsolete? Can assurance on internal controls be more effectively and efficiently obtained without the traditional focus on process improvement as well?
- Is fraud investigation an assurance service? Who are the customers and how is value added?
- Are separate implementation standards needed for fraud investigation? Would the adoption of such standards have significant ramifications for challenges in court to investigation results?
- How can the internal audit function demonstrate that the assurance engagements it has performed have added value to the organization?

### **Consulting Services**

- How do internal audit functions determine which consulting engagements to accept?

### **Issues in Providing Assurance Services**

- Do all engagements provide the same level of assurance? Is there a need for different levels?
- Does the amount of assurance attributed to a report vary as one moves from the operating level to executive management to the board? What factors in the structure of the report (presence of an opinion, length of report, quantification of findings, etc.) impact the user's attribution of assurance?
- What is the relation of evidence requirements to the type and level of assurance being provided?
- Should internal audit provide assurance to parties outside the organization? What are the risks and rewards of doing so?

- Can audit engagement be designed to provide at least some level of assurance that no fraud exists in an area?
- What sort of alignments of “red flags” trigger, or should trigger, the decision to pursue investigation? How should allegations of fraud be evaluated to determine if investigation is warranted? Are there characteristics of the allegation that influence how the cost of moving to investigation when no fraud is occurring should be balanced with the cost of not investigating when there is fraud?
- What sort of assurance (if any) is actually provided by a fraud investigation? Assuming some degree of assurance is provided through the investigation, is the level of assurance symmetric relative to the outcome (no fraud found versus fraud found)?
- Should there be standards of practice regarding how investigations are conducted? Why have there been no standards developed for investigation when there is such a proliferation of standards for other assurance services? What is unique about the environment and process of fraud investigation that explains this lack of demand for standards?

#### **Issues in Providing Consulting Services**

- Can consulting engagements be structured to provide assurance?
- Can a mechanism be developed to allow internal audit functions to systematically allocate resources between assurance and consulting to maximize internal audit’s value to its organizations? How do changing customer demands influence the balance between assurance and consulting services?
- Can an internal audit function only provide consulting services?
- Are there consulting services that internal audit should not provide?
- What are the risks for the internal audit function in providing consulting services and how can they be managed?
- What are the rewards of providing consulting services and how can they be measured?

**Footnote**

<sup>1</sup>CAE refers to the term “chief audit executive.” This is the top position within an organization responsible for the internal audit function. This is the internal audit director (general auditor, inspector general, etc.) in traditional internal audit structures. However, when internal audit services are obtained from outside providers, the CAE is the person responsible for overseeing the service contract and other duties specified in *Standards 2010 to 2060*.



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