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Risk management

The reinvention of internal control and the changing role of internal audit

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Abstract *The publication of the Turnbull guidance represented a radical redefinition of the nature of internal control as a feature of corporate governance in the UK, explicitly aligning internal control with risk management. This paper explores this change, using sociological perspectives on risk and its conceptualisation to frame the debate about internal control and risk management within the UK corporate governance arena – the most recent manifestation of an ongoing competition for the control of economic and social resources. The paper demonstrates that developments in corporate governance reporting requirements offer opportunities for the appropriation of risk and its management by groups wishing to advance their own interests. This is illustrated by a review of recent changes in internal audit.*

Introduction

The current emphasis on the notion of risk is central to a social contest over the control of the economy and society. Fukuyama's thesis that history has ended with the triumph of liberal democracy and free(ish) markets over alternative economic and political systems has been widely discussed (see for example Fukuyama, 1992; Burns, 1994; Bertram and Chitty, 1994). On the contrary, we suggest that the contest for the control of economic and social resources is continuously evolving and that the corporate governance movement is but its latest manifestation. Fifty years ago and less, contention for the control of resources was framed in terms of the ownership of the means of production, particularly whether resources should be owned by the state or be in private ownership. In the UK, extension of state ownership ceased to be a serious political force towards the end of the 1970s and was completely eclipsed during

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the long premiership of Margaret Thatcher. As the extent of social ownership receded during the 1980s with successive privatisations, the contest for resources shifted from ownership to control. Largely the contest was between the state and the management of corporations. One direction in which it was forecast that the contest would develop was in the arena of regulation (Hopwood *et al.*, 1990, p. 78). The USA was seen as the bellwether for future developments and some commentators foresaw an ever increasing tide of regulations and legal restrictions which would eventually drown out the possibility of entrepreneurial behaviour.

This prediction has remained generally unfulfilled and a key platform used by corporations to resist such developments has been a series of arrangements described in various formats as self-regulation. The success of the self-regulation model is that it serves the interests of the agents of the state, the groups being regulated and the institutional representatives of those groups. The impetus for regulation is frequently some kind of scandal or *cause celebre* which produces public pressure for some mechanism to prevent future occurrences (Watts and Zimmerman, 1986, p. 227). A self-regulation solution suits all parties – the industry group avoids state regulation (which is seen as inflexible and difficult to influence), the agents of the state avoid taking responsibility for a function which they know will be the subject of future scandals which would then be unavoidably their responsibility, and institutional representatives gain control, power, resources and prestige.

The reluctance of the state to intervene has, however, meant that stakeholders and interest groups who would, in earlier times, have lobbied the state for control of resources have instead sought to participate in the self-regulatory process. Corporate governance has become the arena in which this now multilateral competition takes place:

> Corporate governance reflects the power relations and political settlements between shareholders, creditors, management and labour as they are embodied in a particular institutional history (Jackson, 2000, p. 266).

For reasons which we discuss below, the concept of "risk" has become central to corporate governance and has become linked to the idea of internal control. In the process, the meaning of both terms has shifted. The shift is symptomatic of important changes in the way corporations govern themselves.

Risk-taking is fundamental to business activity. Limited liability reduces the risk of investing in corporate organisations but the consequent separation of ownership from control carries the risk to investors that company directors will diminish the resources entrusted to them, rather than increase shareholder wealth. Limited liability also reduces the security enjoyed by lenders and provides incentives for increased risk taking on behalf of shareholders. These risks are managed within the corporate governance framework through accountability mechanisms, such as financial reporting, internal control and audit.

The nineteenth century expansion of the incorporated structure of business enterprise was facilitated by the development of this framework, but in the UK concern about its adequacy to meet the needs of the current economic environment followed the financial scandals of the 1980s and led to the establishment of the Combined Code on corporate governance[1]. Internal control has been central to this process.

The final component of the Combined Code was the guidance for directors reporting on internal control issued by the Turnbull committee in 1999. These requirements extend beyond the purely financial to embrace the broad range of risks experienced by companies and internal control is now explicitly linked to risk management. This represents a change in the relationship between risk and accountability: recent developments in audit have appropriated risk management as an accountability process. This paper explores the potential impact of this linkage on those traditionally most concerned with internal control systems – internal auditors.

The paper is organised as follows: the first section discusses conceptual approaches to risk, the second section examines the conceptualisation of internal control and risk management in the context of the UK corporate governance debate, the third section illustrates the potential impact of this conceptualisation on the role of internal audit and the final section draws together the central arguments and suggests further areas for research.

Conceptual and social approaches to risk

This section reviews the changing notions of risk and relates them to current approaches to risk management as a prelude to discussion of changes in the nature of internal control.

The historical progression of the notion of risk and its management can be traced back to the pre-modern era when risk related to natural events which were beyond human agency. Risk management, as currently understood, was largely absent. The seventeenth century development of rationalism suggested that both the natural and social worlds could be subjected to scientific exploration: once techniques for the prediction and calculation of risk became available, it could also be avoided and compensated for. Risk became associated with unanticipated outcomes of human action, rather than simply the result of fate or "acts of God". Subsequent advances in science and technology, while offering protection against some risks, have also created new ones, giving rise to demands for effective risk management processes to deal with an increasingly complex "risk calculus" at individual, organisational and societal levels.

Douglas (1992) argued that blame is central to the structure of societies and organizations, which is reinforced by methods of placing blame and accountability. In pre-modern society, misfortune was attributed in three ways:

(1) moralistic (based on ideas of sin and followed by expiatory action of some kind);

(2) the work of individual adversaries (followed by vengeance and/or compensation); and

(3) the work of an enemy group external to the community (followed by communal punishment and/or compensation).

Douglas asserted that these three types of blaming influence the system of justice that develops within a community, working to bind it together. The development of technology has led to a belief that the "real" risks and the "real" culprits may now be identified:

> Somehow, it was thought that science had really made the things different for us . . . thanks to our accurate knowledge of the world and our powerful technology, our blaming behaviour went direct to real causes instead of being deflected to the constitution-supporting function it performed elsewhere (Douglas, 1999, p. 7).

Although the link between morals and risk has apparently disappeared as risk analysis has become professionalised, modern society and organizations still "use" risk in the same way as pre-modern societies did:

> Just as transgression became the salient point of reference for blaming for disaster in the Bible, and sin in the history of Christianity, in our secular, scientific world, risk has become the convenient, conspicuous blame term that all parties connive to promote (Douglas, 1999, p. 22).

Similarly Hood *et al.* (2001, pp. 176-7) noted that avoidance of blame and liability was a fundamental imperative influencing the structure and processes of the risk regulation regimes they investigated and that the "blame prevention re-engineering" was a theme that linked business risk management in both the private and public sectors.

Like Giddens[2], Douglas (1992, p. 15) observed that, drawn out of smaller local groups into a globalized community, individuals feel vulnerable: the notion of being able to manage risk provides some comfort.

Alongside the changed conception of risk as manageable, new forms of accountability become necessary. As risks become measurable and quantifiable, avoidance and protection strategies are possible. The accountability mechanisms of blame-placing, associated with communal systems of morality and justice, are replaced by financial and other forms of compensation. As techniques of risk management become more sophisticated, accountability mechanisms may also be managed in a way that blurs responsibility. Beck (1998, p. 18) observed that:

> . . . risk societies are characterized by the paradox of more and more environmental degradation, perceived and possible, and an expansion of environmental law and regulation. Yet at the same time no individual or institution seems to be held specifically accountable for anything.

Like Douglas, Beck (1998, p. 15-16) observed that scientific advance meant that external agencies could no longer be blamed for risk. He argued that, once risks became calculable, risk management became institutionalized, citing the welfare state as an example:

> The welfare state can be seen as a collective and institutional response to the nature of localized risks and dangers, based on principles of rule-governed attribution of fault and blame, legally implemented compensation, actuarial insurance principles and collectively shared responsibility.

However, Beck's concept of the "risk society" is characterized by a breaking down of such systems in the face of the "manufactured uncertainty" that arises from technological advance, leaving a state of "organized irresponsibility". From Beck's perspective, techniques and processes of risk management reduce accountability by masking responsibility, yet, within the debate about corporate governance, risk management has been presented as part of a strategy for meeting demands for accountability. Once there is a public expectation that risk should be manageable, then accountability for risk requires some demonstration that risks are being managed both *ex-ante* and *post-hoc* the materialisation of those risks in the form of adverse events.

Douglas (1986, pp. 84-5) noted that:

> The central method of monitoring is to fasten attention on misfortunes . . . Any major mishap in an organization sparks off questions about responsibility . . . Processes of blame-pinning or exonerating from blame strengthen the pattern of the organization and are actually an integral part of it.

However, the adverse consequences of risk are likely to result from a complex chain of events and circumstances. Blame-placing in this context becomes problematic: it is easier to blame the system or process than any individual, although scapegoats may be needed. Thus the process of managing risk within companies may provide comfort and diffuse responsibility, conferring immunity from blame for the adverse consequences of risk, rather than immunity from the consequences themselves[3]. Immunity is increased by the systems which organizations introduce for the management of risks which materialize. Not only are risk responses that address the consequences of the risk planned in advance, but so are public relations responses. Committees of inquiry are set up to determine the cause of the adverse event and the people adversely affected are reassured that it will never happen again[4]. Inquiries serve the purpose of deflecting, or at least postponing, blame, whether or not they also determine causes and reduce the risk of future similar events.

The historical development of the relationships between risk concepts, responses and accountability can be mapped as in Table I.

Within the broad conceptualisation of risk as manageable, perspectives also differ, ranging from the objective (quantifiable and susceptible to technical/ scientific management) to the socially constructed. Lupton (1999, p. 35) summarised epistemological approaches to risk on a continuum ranging from a realist position where risk is seen as objective and measurable (a technico-scientific perspective) to a "strong constructionist" position which argues that "nothing is a risk in itself" and our understanding of risk is constructed through social, political and historical perspectives. These divergent views on the meaning of risk were clearly illustrated in the disagreement between physical and social scientists involved in preparing the Royal Society's 1992 report

	Conceptualisation of risk	Response to risk	Accountability for risk
Pre-modern	Fate, superstition, sin	Acceptance, blame	Expiation, punishment, vengeance, retribution
Modern	Calculable, quantifiable	Avoidance, protection	Compensation, e.g. financial
"Risk society" (Beck)	Manageable	Control and regulation via systems, based on expert advice Systems for response and blame avoidance	System amendment, extended control

Table I.
The historical development of relationships between risk concepts, responses and accountability

Risk: Analysis, Perception and Management (Adams, 1995, p. 7; Douglas, 1999, p. 218).

However, the relationship between these conceptualisations is more complex than this apparent diametrical opposition might suggest.

Cultural theory offers one example of a constructionist approach, drawing on the work of Mary Douglas mentioned above. Cultural theorists such as Rayner (1992) have argued that the conventional (technico-scientific) conceptualisation of risk and its management is essentially reactive: risk perception is a response to an external stimulus and is communicated, often in the form of quantitative information, and generates processes of risk management, which are directive and procedurally based. Cultural theory offers a different approach, proposing that risk perception is an active process, since societies and organisations select risks for attention.

Within cultural approaches it is possible to distinguish several kinds of risk regulation regime. Hood *et al.* (2001, p. 13) use Douglas' grid-group model to label four modal types as "fatalist", "hierarchist", "individualist" and "egalitarian". The fatalist mode corresponds most nearly to a pre-modern approach in which adverse events are "bad luck" and responses are *ad hoc*. Such modes can still be discerned in responses to adventure tourism and natural disasters, especially outside the developed world. The hierarchist mode is closely related to the technico-scientific approach and emphasises expert forecasting and management. The Royal Society (1992) approach is an example. The individualist mode emphasises individual choice and market processes whereas the egalitarian mode emphasises community decision making and a "Rawlsian" model of justice in which protecting the worst off is a priority. In practice, specific regimes will exhibit characteristics drawn from one or more modes. In the context of the UK corporate governance debate, the technico-scientific approach forms the basis of a rhetoric that links the processes of risk management to good governance. Yet within organisations, because of the way different risks are subject to different, and hitherto unintegrated, regimes, there is likely to be no consensus about the meaning of risk and the appropriate ways to manage it. We suggest that it is precisely because risk is a vaguely defined and mutable concept that it has become part of the corporate governance arena. The debate is conducted in a way which fails to specify either the nature of the risks or on whom they are expected to have an impact. Despite this, corporate governance risk management rhetoric assumes that risks can be objectively identified, quantified and thus strategically managed.

Thus expertise in risk management techniques becomes a source of power which may enable interest groups to secure positions of influence within organisations, by appropriating and redefining the concept of risk and its management to suit their own purposes, a constructionist perspective. An illustration is the changing role of internal audit: the next section provides a context for an examination of this by outlining the development of corporate governance policy in the UK, with particular reference to the role of internal control and its association with risk management and how the concept of risk, as it has evolved, became a solution to a particularly knotty corporate governance problem.

How internal control became risk management

This section discusses the difficulty of defining internal control, traces its role in the development of UK corporate governance policy and identifies those groups who benefit from the redefinition of internal control as risk management. Since the problem of reporting on internal control has proved so intractable in the UK, we set out in some detail the course of official deliberations and the emergence of risk management as a key concept.

Corporate governance concerns in the UK have centred on financial aspects, seeking improved financial controls and financial reporting quality to strengthen the accountability of boards to shareholders. Risk in a financial context is generally understood to be the potential for financial loss consequent on fraud and incompetence. Although it is widely recognized that such risk can never be entirely eliminated[5], it is generally believed that a system of internal control will act as a deterrent to fraud and a protection against incompetence. The provisions of the Cadbury Code, published in 1992, were explicitly designed to improve internal control mechanisms, based on the assumption of a relationship between internal control, financial reporting quality and corporate governance[6].

From the first authoritative definition of internal control by the American Institute of Public Accountants in 1949 to the definitions which still exist in professional pronouncements (see for example APB, 1995), there seems to have been no substantial change of meaning[7], yet a sea change in the internal control of companies was underway during the 1980s and 1990s. We identify two factors which precipitated this change: growth of information technology; and changes in audit methods. The technological change began when maintenance of records on databases that were updated in real time became widespread. The emergence of the large relational database and the reduction in the cost of software for accessing and manipulating databases meant that system amendments were frequent and that traditional processing controls, such as batch totals, became obsolete. Computer systems are now largely customised versions of standard software constructed by consultants from outside the organisation. Within an organisation, documentation of such systems is usually incomplete and nobody knows in detail how they really work.

At the same time, with the waning of governments' appetite for intervention, external auditors were in an unusually weak position. In the late 1980s they were under pressure to reduce fees and to make themselves more "relevant" to the management of their clients and the business risk approach to the external audit was conceived. Another sign of auditors' weakness was the rampant use of creative (now "aggressive") accounting by their clients which they seemed powerless to stop. The auditors responded to the pressure to reduce costs and increase reliance by developing "business risk" approaches to auditing in which documentation of systems and detailed testing was drastically reduced.

Both changes in technology and auditing encouraged a devolution of control downwards in organisations, and rigidly enforced compliance with policies and procedures was replaced by the rhetoric of risk in which the upper levels of the organisation focus on the risks which are perceived to be important.

In both the UK and the USA, governments were taking a *laissez-faire* attitude to regulation. The response of the professions and concerned stakeholders, seeing that the lobbying of government was now wasted effort, was to open up a debate on the way corporations are run; to clear a space for what was to become the corporate governance arena.

In the US the Treadway report (Treadway, 1987) focused on the prevention of fraudulent financial reporting and stimulated a world-wide debate on a range of corporate governance issues. The organisations which sponsored Treadway (COSO) produced a further report in 1992, specifically addressing the role of internal controls in securing improved corporate governance (COSO, 1992). It contained an analysis of features of internal control and a framework for its establishment and evaluation. The report defined internal control as:

> A process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations.
> - Reliability of financial reporting.
> - Compliance with applicable laws and regulations (COSO, 1992, p. 9).

The incorporation of "effectiveness" was the first radical change to the idea of internal control in over four decades. By admitting "effectiveness" – the extent of achievement of objectives – into the ambit of internal control, the statement recognises for the first time the existence of business objectives other than efficiency and probity and goes some way to aligning the definition with business risk approaches to audit.

More recently, the Canadian Institute of Chartered Accountants has developed a Criteria of Control Framework (CoCo) which provides a definition of control and a series of criteria for assessing its effectiveness (Canadian Institute of Chartered Accountants, 1995). This reflects a much broader approach to control and risk, directly related to the achievement of organizational objectives. Both COSO and CoCo clearly extend their definitions beyond financial control alone, but defining internal control boundaries remains problematic. Maijoor (2000) explored the difficulty of defining internal control and discussed the implications of this lack of clarity for the development of corporate governance policy and European financial auditing markets. He identified three varying perspectives on internal control in the academic literature – those of external audit, organization theory and economics – and, noting that research in this area is fragmented and under-developed, argued that the role of internal control in corporate governance is unclear, leading to policy recommendations based on unproven assumptions. One such assumption is that internal control reporting contributes to improved corporate governance. Analysis of US demand for reporting on internal control demonstrated that doubts about this remain unresolved (Hermanson, 2000). No equivalent research has been undertaken to date in the UK, where the following examination of the development of corporate governance policy further illustrates the problem of internal control definition.

The increasing importance of internal control in the UK context can be traced through the development of the Combined Code to its present form. The Cadbury Committee's remit was limited to financial aspects of corporate governance only. The Cadbury report recommended that:

> Directors should make a statement in the report and accounts on the effectiveness of their system of internal control and that the auditors should report thereon (Cadbury Committee, 1992, 4.32).

To facilitate this, the accountancy profession was recommended to develop criteria for assessing effectiveness, together with guidance for companies on the form of such reports and guidance for auditors on procedures and the form of reports. As Power (1997, p. 55) has noted, this section of the Code was seen as controversial: directors and auditors were reluctant to make such statements when internal control effectiveness remained a nebulous concept.

The requirement to report on internal control has all the hallmarks of a hostage to fortune – an item included by the Cadbury Committee without realising what difficulties it would cause. It seems plausible that the accountants involved with Cadbury trained at a time when auditing was based on the systems approach and auditors were at pains to record and evaluate internal control systems. By the early 1990s, however, audit risk approaches were well advanced and external auditors did not understand, record or evaluate large areas of clients' systems. In this world, it is probably the internal auditors who know or understand best what a company's internal control system is (even if they do not understand aspects of the computer systems). This may be an important uncontested jurisdiction from which internal audit can advance within an organisation.

The Rutteman working party was set up to address this Code requirement and reported in 1994. Rutteman used the COSO definition of internal control but emphasised that the Cadbury Code related to financial aspects of corporate governance and thus internal financial control. This was defined as:

> The internal controls established in order to provide reasonable assurance of: a) the safeguarding of assets against unauthorised use or disposition; and b) the maintenance of proper accounting records and the reliability of financial information used within the business or for publication (Rutteman Report, 1994).

Sidestepping issues of "effectiveness", this placed the emphasis for internal control reporting very firmly on the second of the objectives identified by COSO, although Chambers (1997) commented that the safeguarding of assets would have implications relating to both operational and compliance issues and thus automatically extended the scope of consideration.

Section 8 of the Rutteman Report prescribed the minimum content of the directors' report on internal control:

> (a) acknowledgement by the directors that they are responsible for the company's system of internal financial control;
>
> (b) explanation that such a system can provide only reasonable and not absolute assurance against material misstatement or loss;
>
> (c) description of the key procedures that the directors have established and which are designed to provide effective internal financial control; and
>
> (d) confirmation the directors (or a board committee) have reviewed the effectiveness of the system of financial control.
>
> Directors may also wish to state their opinion on the effectiveness of their system of internal financial control (Rutteman Report, 1994).

The Cadbury prescription that directors should report on internal control effectiveness was replaced by the suggestion that they may wish to do so. Chambers (1997) surveyed the response to Rutteman, suggesting that this weakening of the Cadbury recommendations was the result of lobbying by finance directors who feared litigation.

The Cadbury Committee had recommended that a successor body should revisit the issues covered and this task was given to the Hampel committee, established in 1995 and finally reporting in 1998. In the intervening period, the major governance preoccupation had been directors' remuneration, shifting the focus away from financial reporting issues. The Hampel report adopted a very different tone to that of Cadbury and began unequivocally:

> The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past

> few years. We would wish to see the balance corrected . . . the emphasis on accountability has tended to obscure a board's first responsibility – to enhance the prosperity of the business over time (Hampel Committee, 1998, p. 7).

The original expressions of the committee's views on this were even stronger. In the committee's preliminary report, published in August 1997, the second sentence of this extract read:

> In the UK the latter has preoccupied much public debate over the past few years to the detriment of the former.

The second paragraph of the preliminary report also included the sentence, dropped from the final version:

> It is important to recognise that there is no hard evidence to link success to good governance, although we believe good governance enhances the prospect.

These changes were viewed by commentators as cosmetic: the tone of the report still conveys the clear assumption that governance and accountability do not enhance entrepreneurial activity, although no evidence is provided to support this view (Bruce, 1998).

The amalgamation of the Cadbury, Greenbury and Hampel recommendation into the Combined Code of the Committee on Corporate Governance included explicit statements about the role of the board in relation to internal control:

> The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets (Principle D.2).

> The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management (Provision D.2.1).

Guidance for directors on meeting the Combined Code requirements was subsequently provided by the Turnbull Committee in 1999. Turnbull characterised the elements of a "sound" system of internal control (but avoided giving examples of the likely components of such a system) and outlined a process whereby boards could fulfil their responsibilities in this area.

From Cadbury onwards, internal control has clearly been conceived as a system, in contrast to the broader approaches of COSO and CoCo. The Turnbull report moves towards an expanded view. It is the first public document relating to UK corporate governance to emphasise the relationship between internal control and business risk: although Hampel referred briefly to risk management in the context of internal control, Cadbury did not explicitly link the two. Advice for directors from the ICAEW on how to implement the Turnbull requirements goes even further, coupling internal control with risk management throughout (Jones and Sutherland, 1999).

These developments are summarised in Table II.

The trend away from a narrow internal control scope with a high level of reporting requirements towards a broader scope with less stringent reporting is illustrated in Figure 1.

However, the relationship between internal control and risk management remains confused. The Canadian Institute of Chartered Accountants (1999, p. 9) Criteria of Control Board perceived control as encompassing risk: "Control should cover the identification and mitigation of risks". Krogstad *et al.* (1999, p. 33), interpreting the new IIA definition of internal auditing, commented that:

> . . . the new definition recognizes that controls do not exist in a vacuum and implies, rather, that controls exist to assist the organization in managing its risk and to promote effective governance processes.

The COSO framework identified risk assessment as one of the five components of internal control, whereas Turnbull stated that:

> A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives (Internal Control Working Party, 1999, p. 4).

An IIA-UK (1999) publication *Effective Governance* quotes an internal auditor at a major UK plc who describes control as a "subset of risk management". Blackburn (1999, p. 36) noted this confusion and asked: which should come first, risk or control? Providing no answer to this question, she argued that the prime focus should be the achievement of business objectives, suggesting that the source of the definitional problem lies in the artificial separation of risk

	Cadbury	Rutteman	Hampel	Turnbull
Scope	Internal financial control	Internal financial control	Internal control (all controls, including financial, operational and compliance controls and risk management)	Internal control and risk management
Reporting	Effectiveness	Review undertaken may report on effectiveness	Review undertaken	Review undertaken

Table II. Scope and requirement for reporting on internal control effectiveness

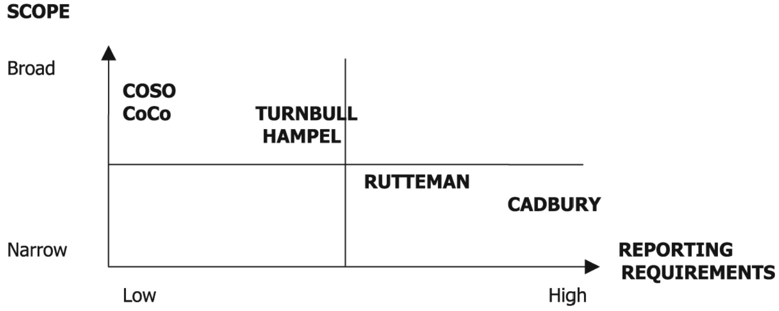

Figure 1. The trend away from a narrow internal scope towards a broader scope

management and internal control from the central business activities to which they are integral.

The focus on risk management, which comes with a panoply of techniques for risk identification and assessment, not only avoids the difficulty of defining internal control – it also links neatly to the shift in the corporate governance debate from a focus on financial reporting quality to a concern that corporate governance mechanisms should not impede enterprise[8]. The Hampel report argued that the regulation of the downside of risk through internal control was achieved at the expense of the recognition of the positive view of risk which underpins enterprise. The redefinition of internal control as risk management emphasizes links to strategy formulation and characterizes internal control as a support for enterprise. It also glosses over the uncomfortable truth that nobody now knows exactly what the internal control system is.

Who benefits from the conceptualisation of internal control as risk management?

In complying with Turnbull, directors can rely on assessing the effectiveness of risk management systems rather than having to grapple with the more nebulous meaning of "a sound system of internal control". External auditors have already identified the advantages of marketing their audit services as integrated with corporate strategy through a risk focus (Lemon *et al.*, 2000), thus adding value; specialised risk management consultants offer advice on Turnbull implementation.

Boards are urged to recognise the potential contribution of internal audit in taking the lead as pre-eminent advisers:

> Other assurance functions are not usually positioned in the organisation and reporting structure with the same overview and degree of independence as internal audit (ICAEW, 2000, p. 9).

Turnbull has extended the requirements for directors to report on internal control beyond the purely financial to embrace the broad range of risks experienced by companies. Since all such risks have a potential financial implication, this is logical. It does not imply that the consequences of business, operational or compliance risks have previously been neglected or ignored. They have, however, been seen as the province of different departments within companies (Lilley and Saleh, 1999). To comply with Turnbull in a cost-effective way, we may expect that companies will now seek to combine areas of risk assessment and risk management currently dispersed. This, in turn, implies a jockeying for position among those involved. Power has suggested that the "internal regulatory space" provides an arena within which internal corporate interests will also compete (Power, 1999a, p. 17). Some companies with an established internal audit function have already expanded this to include specialists such as engineers and marketers to give a broader operational perspective on risk. In the next section we explore in more detail the potential impact of the redefinition of internal control as risk management on internal auditors.

The metamorphosis of internal audit

In this section we trace the development of internal audit and compare the rhetoric of the associations seeking to professionalise the activity with the changes which are occurring in the work of internal auditors as a result of external pressures and the opportunity to expand their remit which the redefinition of internal control affords.

Historically, internal audit has been viewed as a monitoring function, the "organizational policeman and watchdog" (Morgan, 1979, p. 161), tolerated as a necessary component of organizational control but deemed subservient to the achievement of major corporate objectives. An examination of the pressures on internal audit in recent years reveals the struggle to demonstrate that the function can add value.

Outsourcing of the internal audit function became popular during the 1980s as the costs of internal audit were being closely scrutinized in many companies, often as a result of the application of business process re-engineering techniques. The move to outsourcing was one of the driving forces for change in internal audit. The large accounting firms saw opportunities for new business. Bruce (1996) suggested that a risk management approach to strategy by top management and a desire to view it in an integrated way was an impetus towards integration of external and internal audit, but the need for independence of external auditors provided a countervailing pressure. The response of the internal audit community has been to emphasise professionalism and the potential of internal audit to add value.

Kalbers and Fogarty (1995) observed that discussions about professionalism have exercised internal auditors for many years. In 1979, Morgan identified the aspiration of internal auditors to move from "controller" to "controller-adviser" as part of the process of professionalisation of internal audit, noting that this shift "can only be successfully achieved at the cost of surrendering certain elements of the controllership role, and some of the claims to formal authority which go along with it" (Morgan 1979, p. 168). He observed that internal auditors found it problematic to relinquish such claims, and cited difficulties encountered when internal auditors, having attempted to establish a co-operative relationship with auditees, were obliged to resort to formal authority to obtain access to information or to deal with problems revealed by audit. He noted that:

> . . . recent IIA pronouncements which emphasise how internal audit should provide a "service to the organisation" and how internal auditors should become more accountable to Audit Committees of Boards of Directors and society, rather than exclusively to management . . . signal the definition of a role and power base which returns to the philosophy of the original audit role . . . but which carries with it an expanded conception of the audit function which . . . seeks to combine control and advisory functions, by orienting the latter to the highest organisational levels (Morgan, 1979, pp. 169-70).

Twenty years after Morgan's observations, the Institute of Internal Auditors promulgated a new definition of internal auditing which focuses on independence and objectivity, identifying an assurance and consulting role for internal audit and emphasizing adding value and improving effectiveness of risk management, control and governance processes. Krogstad *et al.* (1999, p. 33) outlined the development of this new definition and noted that "internal auditing's interface with governance raises the stakes for the profession".

Although this new interest in the potential of internal audit to contribute positively to corporate objectives offers an opportunity for a stronger claim to professional status, difficulties remain. Pentland (2000), seeking to establish the boundaries of audit, observed that auditors are experts in process rather than content: in areas such as environmental audit, specialists from other disciplines offer strong competition to the expert status of the traditional internal auditor. Similar challenges are encountered in the area of risk management and may be rebutted by the assertion that internal audit has the advantage of independence (ICAEW 2000, p. 9) but the tension remains between the consultancy role of internal audit and claims of independent status.

Fogarty and Kalbers (2000, p. 134) explored a range of dimensions of professionalisation in internal audit, identifying independence, autonomy and self-regulation as key attributes, but cautioning that:

> . . . organisations should also be aware that internal auditing inherently involves role conflict. Efforts to eliminate role conflict may deny internal auditors the very essence of their roles in the organisations.

Claims for professional status both support and are supported by the identification of areas in which professional expertise may be demonstrated. The financial scandals which provoked world-wide concern with corporate governance in the 1990s highlighted apparent failures of accountability[9]. Inevitably audit and internal control, mechanisms designed to secure accountability, became a focus for the debate about reform. Internal auditors, traditionally specialists in internal control but not highly regarded within organisations, have attracted the attention of boards grappling with external demands for assurance about corporate governance practice.

Thus Turnbull's broader approach to internal control has offered internal audit the opportunity to claim expertise in the crucial area of risk management. The power base of internal audit is firmly established: it is a key component of good corporate governance practice. But to what extent has the opportunity identified for extending this advantage been exploited by internal auditors?

There is a consensus that important changes are occurring in the nature of internal auditing. McNamee and McNamee (1995) characterised the history of internal auditing since the second world war as one of a transformation from validation of transactions to one of systems auditing. They also detected a change in which internal auditors became "a primary agent for transformational change" in helping users of systems to "design test and monitor their own controls".

Power (1999a, b) suggested that there has been a fundamental change in the nature of corporate governance from "regulation from above" to "regulation from the inside" and that the key to what he calls this "proactive compliance based style of regulation" is a "risk based future orientation". Risk management is integral to "the new self-governance of the organisation". Despite Power's world view of an "audit society", it is likely that there is growing divergence of compliance cultures. In many risk oriented approaches compliance is downplayed. Where risks are regarded as minimal or susceptible to local management, procedures may not be documented and compliance not assessed: at the same time, innovative risk management solutions are actively sought which may not require procedural compliance. As previously noted, different risks are subject to widely different regimes and a compliance culture is only one kind of regime.

However, the extent to which such changes have permeated organisations is not yet known. Internal auditors are certainly exhorted in the professional literature to embrace the opportunity to contribute to the achievement of corporate objectives through risk management: for example, Deloitte and Touche Tohmatsu (2000, p. 6) asserted:

> The shift in the risk-control landscape creates both challenges and opportunities for internal auditors. Those that handle the challenge quickly and cost-effectively will be credited with helping their organisation meet its business goals. Those that don't will be left behind, stranded in a world where the attitude "you are either part of the problem or part of the solution" separates the survivors from the casualties. There is still much work to be done and we hope that internal audit professionals will see beyond today and carve a vision worthy of tomorrow.

Other evidence demonstrates that internal auditors certainly aspire to this reframing of their role in terms of risk management: examples are offered by the new definition of internal auditing issued by the Institute of Internal Auditors in June 1999, as well as commentary in recent articles (e.g. Bou-Raad, 2000; Chambers, 2000). Chambers observed the increasing references to risk over the last five years in the strap lines of professional journals and newsletters relating to internal audit, as well as an increasing focus on risk in the titles of articles therein (Chambers, 2000).

It is less clear that this ambition is being achieved. Research into organisations known for their leading edge risk management practices (Selim and McNamee, 1999) shows an alignment of risk management and internal audit practice, but the authors acknowledge that this is by no means universal and identify changes in culture and competencies required of other internal audit functions if they are to go in the same direction. The Selim and McNamee model is one in which risk assessment is followed by risk management and risk communication: however, their descriptive model of leading risk managers is one in which internal audit is derived from the strategic planning process rather than a process which contributes a great deal to it.

Survey research by Griffiths (1999) is more broadly representative of current practice. In a questionnaire study of fellow FTSE 200 finance directors he found widespread "lukewarm" or "negative" attitudes to internal audit and that the function was frequently seen as "too low key and basic (and therefore insufficiently business risk-oriented)" and that the function was lacking in skills and appropriately trained staff.

A survey of senior executives and senior internal auditors carried out by KPMG in the USA (KPMG, 1999) indicated that a higher percentage of internal auditors than senior executives expected internal audit to have a developing role in identifying and evaluating risk. Twice as many internal auditors as senior executives viewed risk management as the means by which internal audit added value (senior executives saw the internal audit role as principally to ensure internal control effectiveness, indicating that both groups saw these as distinct functions, unlike the UK view represented in Turnbull). Internal auditors also had a stronger perception of their current ability to assist in risk management activity than senior executives did; but senior executives expressed a strong wish for this area to be developed.

A similar survey by Deloitte and Touche Tohmatsu (2000, p. 10) in New Zealand reported that:

> . . . there are no major significant differences in perception [of the future role of internal audit] registered by all respondents, apart from internal auditors' expectation of a larger role in assessing operational efficiency and organisational performance, than chief executives expect.

The growth of concern for corporate governance has been of great benefit to the standing of internal auditors and has boosted their claims to professional status by emphasising the benefits of independence of judgement and objectivity in their reports. An occupation which was once confined to checking mundane compliance with systems devised by others has become elevated to professional status and with a line of reporting to the higher levels of the company.

Conclusion

This paper began by indicating the advantages of self-regulation for state and corporation alike, observing that stakeholders now compete to participate in the self-regulatory process, rather than for control of resources, and that corporate governance policy is one arena for this contest. A focus on risk management has become central to this competition since it defines the accountability of the management of the organisation.

The corporate governance framework was designed to manage risk through, *inter alia*, the accountability mechanisms of financial reporting, audit and internal control. Mapping the development of the conceptualisation of risk against associated response and accountability mechanisms demonstrates that notions of risk are mutable and continue to evolve. The analysis offered by cultural theorists argues that the perception of appropriate regulation of risk will vary, according to the characteristics of specific risk regimes. This suggests that interest groups may seek power in organisations by asserting their own conceptions of risk and how it should be managed. In particular, modern conceptions of risks within organisations can lead to "blame avoidance". At the same time that risk management was becoming prominent in managerial concern, internal control was under examination, partly because of well-publicised corporate failures and partly as a result of moves towards professionalisation of the internal audit function. Rapid changes in information technology and managerial practices in many organisations were forcing moves away from rigid, documented control to situations where responsibility for control was being pushed down the organisation hierarchy and where oversight by management could not be achieved through traditional, compliance based internal audit.

The observation that, within corporate governance policy, risk management has become closely aligned with internal control suggests that the extent to which risks are managed has now been annexed as a form of accountability, rather than its focus – a yardstick against which a dimension of performance is measured. This redefinition offers a new view of risk management as part of the accountability process, implying a shift which blurs the distinction between responses to risk, through risk management systems, and accountability for risk, supporting Beck’s thesis that, despite extended regulation, specific accountability is difficult to attribute to individuals or institutions; the possibility arises that risk management has been adopted as much for its potential for blame avoidance as for improved accountability. The paper has explored this through an analysis of the process of reinvention of internal control as risk management and an examination of the impact of this redefinition, as embodied in the Turnbull guidance, on internal audit. Internal auditors have been exhorted, by those seeking to establish their professionalisation, to present themselves as risk management experts, basing this expertise on their familiarity with internal control processes, but the extent to which this aspiration has been achieved in practical terms is unclear and should form the focus of future research.

The debate on corporate governance and reporting on internal control in the UK illustrates the competition occurring in the arena. The reassertion of the importance of risk in the generation of shareholder value by the Hampel report may have been the high-water mark of the ideology. Two years of stock market decline and the recent debacles at Enron and Allied Irish Bank have left managements less anxious to draw shareholders’ attention to the performance of their investments, and widespread failure to achieve corporate objectives provides a natural focus for business risk management. In the process, risk management has been transformed from a “technico-scientific” concept to a more loosely defined one which attempts to assemble a range of disparate regimes under a single umbrella. Nevertheless, the rhetoric of risk management has become a source of organisational power and opportunity.

Internal audit faces both threats and opportunities from the changing shape of organisational process. The threat is that the rate of change of systems and processes is too great for traditional, compliance based internal audit to work: the opportunity, greatly enhanced by Turnbull, is to occupy the organisation vacuum which the new risk management focus provides. It is apparent that there may exist some kind of “rhetoric gap” in which the standard bearers for internal audit are proclaiming a vision of what internal audit is changing into, whereas the practice in organisations may be substantially different. If this is so, there is a potential for significant adjustment costs as businesses are forced to implement the Turnbull report from an inadequately prepared internal audit and control environment. Empirical research into the impact of Turnbull on boards, audit committees, internal and external audit and other business areas managing risk, such as health and safety and environmental management, is needed to describe and explain the changes which are taking place in the governance of organisations. Internal auditors can usefully be a focus for some of this research because they are potentially important stakeholders and actors in the risk management process and because their functions spread across organisational boundaries in an unrivalled manner.

Notes

1. The Combined Code amalgamates the recommendations of the Cadbury, Greenbury, Hampel and Turnbull Committees. Companies listed on the London Stock Exchange are required to comply with the Code, reporting on how the provisions have been implemented and explaining any instances of non-compliance.
2. For Giddens (1991, p. 18) modernity is characterized by "time-space distanciation": "the "lifting out' of social relations from local contexts and their rearticulation across indefinite tracts of time-space". This is achieved through the use of "disembedding mechanisms" – abstract systems. Giddens (1991, p. 18) identifies two types of abstract system: symbolic tokens, such as money, and expert systems: "Expert systems bracket time and space through deploying modes of technical knowledge which have validity independent of the practitioners and clients who make use of them". Systems of risk management would fall into this category.
3. This is illustrated in advice to client company boards provided by a major accountancy firm: ". . . bear in mind that although proposals relating to corporate killing have been delayed they have not gone away. Your best defence against this and the growing scapegoat culture we live in is an effective system of risk management and control" (Deloitte and Touche, 2000, p. 14).
4. This process has been raised to a fine art by the British National Health Service where those suffering from medical negligence or incompetence find that if they are able to negotiate the long formalities required to persuade a Health Service Trust to enquire why an adverse event occurred, the enquiry is immediately cancelled if the complainant attempts also to obtain legal redress.
5. "A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgment in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseen circumstances' (Internal Control Working Party, 1999, para. 23).
6. As Maijoor (2000, p. 102) has observed, this assumption has yet to be tested.
7. For example the definition of internal control given by SAS 300 states the internal control system "comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, so far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detect of fraud and error, the accuracy and completeness of the accounting records and timely preparation of reliable financial information. Internal controls may be incorporated within computerised accounting

systems. However the internal control system extends beyond those matters which relate directly to the accounting system" (APB, 1993).

8. See Short *et al.* (1999).
9. The collapse of Enron in 2001 has repeated these concerns *fortissimo*.

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