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The impact of legislation on the internal audit function

Introduction

Today, business organizations are constantly bombarded by many different constellations of change, including challenges and risks in the environment (Sarens and De Beelde, 2006). As organizations operate to carry out their mission, they are exposed to threats and opportunities that can either bolster their growth or bring about their demise. How an organization deals with change and understands its capacity to address the change is a critical factor for its survival.

While there are many factors that could impact the organization, this study focuses on the burgeoning role and changing responsibility of the Internal Audit Function (IAF) as a behavioral response to the environmental change factor of regulation. Therefore, when major changes in regulations occur, pressures can cause organizations to adjust their structures, processes and strategies (Haveman *et al.*, 2001).

This study addresses the following research question, *“How does the environmental change factor of regulation bring about a shift in the Internal Audit Function’s Role in the organization post-SOX?”*

Several studies have focused on management accounting changes from a broad-based perspective across organizational sectors (Burns and Baldvinsdottir, 2005; Quattrone and Hopper, 2001; 2005; Sulaiman and Mitchell, 2005), but only a few have concentrated on the impact of change within the organization. However, there is one particular study (Burns and Scapens, 2000) that is part of a novel trend that analyzes management accounting changes and practices within the organization as a process using the Old Institutional Economics (OIE)

component of institutional theory (Ribeiro and Scapens, 2006). Thus, this study attempts to explain this recent shift in the IAF's roles and responsibilities through interviews conducted with chief audit executives (CAEs) in eight organizations as a function of environmental change resulting from the external pressure of regulation. This study contributes to the literature by extending the work of Burns and Scapens (2000) and Seo and Creed (2002) by developing a new Two-Tiered Organizational Change Framework, which serves as a useful tool to analyze and explain the institutional change in the IAF.

The following sections discuss the background literature, theoretical foundation and the research question; the methodology employed; the findings and a discussion of the findings and implications for future research.

Key Words: Internal Audit, Corporate Governance, SOX

Article Classification: Research Paper

Organizational Change, Sarbanes-Oxley and the Internal Audit Climate

Organizations, like organisms, constantly change adapting to the environment in which they reside. Therefore, it is important to examine the changes that organizations make in response to a changing environment. As organizations encounter environmental changes, their adaptive abilities must be robust enough to allow adjustments for its survival; thus, it is often necessary to revamp the strategy and reorganize the structure. One key example of environmental changes is regulation.

Legislation has had a dramatic impact on organizations throughout history. The impact of the Sarbanes-Oxley Act(SOX) is not unique; other legislation has had a significant impact on the institutional and organizational environment in terms of their strategies, structures and

activities as well (Haveman *et al.*, 2001). The Airline Deregulation Act of 1978 represents yet another example of how the impact of legislation changed the institutional and organizational environment internally and externally. According to Hoffman (1999), these upheavals represent disruptive events that help explain and predict the genesis of organizational change. Further, Haveman *et al.* (2001) suggest that, “all industries are punctuated by discontinuous change, and shifts in regulatory regimes often trigger these upheavals” (p.268). Therefore, the impact of legislation can trigger responses that alter the structure, strategies and activities of the organization going forward.

Sarbanes-Oxley

As corporations and the accounting profession ushered in a new millennium with a plethora of accounting and corporate fraud scandals, questions about the inherent soundness of the corporate governance model were raised. Organizations were violating rules and procedures designed to properly account for transactions; fraud was rampant, and there was no accountability--all symptomatic of the systemic issues in corporate governance. The pivotal point in this crisis was the Enron debacle, the final spark that rendered the corporate governance system ineffective, and signaled a clarion call for deliberate and decisive action. Clearly, there was something egregiously wrong with the corporate governance system and the legislative branch of the U.S. Government was forced to respond. Therefore, strengthening the corporate governance system became a critical priority. As a result, the Sarbanes-Oxley Act was passed by the U.S. Congress to overhaul the system and implement regulatory guidelines to achieve accountability, transparency and reliability during corporate disclosures. As part of this Act, the Public Company Accounting Oversight Board (PCAOB) was created. PCAOB not

only brought regulatory oversight to the auditors, by default, it enhanced the prominence of the internal audit function's role as well (Coates, 2007).

Internal Audit

The IAF was primarily characterized as a monitoring/compliance-based group responsible for enforcing policies and procedures (Spira and Page, 2003). Prior to SOX, the IAF's responsibilities ranged from procedure enforcement to special projects that varied based on the needs of the organization.

Cohen, Krishnamoorthy, and Wright's (2002) empirical study, conducted pre-SOX, evaluated corporate governance and the audit process, and the IAF was not considered at all. In a follow-up study by Cohen *et al.* (2010) to capture the experiences of auditors' post-SOX, there is a stark contrast to the original study as it relates to the IAF. The IAF was leading the compliance effort for SOX and advising senior management on corporate governance and other risk matters. The SOX Act itself has raised the Importance of the IAF as part of the corporate governance framework (Cohen *et al.*, 2004). The subsequent study shows significant involvement and participation from the IAF, thereby demonstrating a shift in their roles and responsibility (Cohen *et al.*, 2004). According to Cenker and Nagy (2004), the study they conducted post-SOX with chief audit executives revealed that SOX had an impact on the relationship between internal audit and the major players, including the audit committee. Thus, the IAF had newly created opportunities to showcase their knowledge and visibility to the organization (Verschoor, 2005).

Literature Review

Many opportunities exist for the internal audit function to play an instrumental role in corporate governance (Gramling *et al.*, 2004; Roussy, 2013; Sarens, 2009), particularly as organizations put in place more effective governance structures and processes. Given the current climate, it is not surprising that the internal audit function is viewed as the ideal resource to assist with improving and supporting key governance processes by monitoring the controls and evaluating the operational effectiveness of management strategies and initiatives (Allott, 1996), with each party responsible for contributing to corporate governance. The Institute of Internal Auditors (IIA) states that,

“The internal auditors, perceived as ‘risk management experts’, can expect to play an immensely significant and high-profile role within organizations for years to come” (2003, p.14).

Therefore, successful corporate governance is contingent upon a fluid relationship among the cornerstones (audit committee, executive management, internal/external auditors), thereby making the internal audit function an integral part of the corporate governance framework (Cohen *et al.*, 2004).

Theoretical Framework

The theoretical foundation for this study represents a bricolage of concepts, constructs and theories derived from the management accounting and organizational change literature (Boxenbaum and Rouleau, 2011; Burns and Scapens, 2000, Roussy, 2013; Seo and Creed, 2002; Van de Ven and Poole, 1995; Weick and Quinn, 1999). Dillard, Rigsby and Goodman’s (2004) study focused on management accounting change using efficient market, agency, structuration and contingency theories. Additional studies centered on evaluating the nature of change (Quattrone and Hopper, 2001; Sulaiman and Mitchell, 2005), but they have been very general

with little empirical work focused on the inner dynamics that occur within the organization, or change as a process (Ribeiro and Scapens, 2006). Thus, researchers began to establish a new precedent by conducting studies that were able to capture insightful data that were context-dependent using a case study approach (Burns and Scapens, 2000; Burns and Baldvinsdottir, 2005; Ribeiro and Scapens, 2006).

Instead of hearkening back to prior studies and theoretical premises, we decided to move forward with the contemporary trend of evaluating change as a process within the organization using institutional theory. Specifically, we use the Old Institutional Economics (OIE) component of institutional theory because the main thrust of OIE research is to discern how management accounting practices and routines become institutionalized (Ribeiro and Scapens, 2006).

Burns and Scapens' (2000) Framework is based on the notion that accounting change can be evaluated through the practices and protocols that are fundamental to espoused beliefs and assumptions. Because of these established *modus operandi*, institutions add stability and continuity to management accounting practices (Burns and Baldvindottir, 2005). Burns and Scapens (2000) go on to add that the process of institutional change can be interpreted by and attributed to external forces which have the ability to amplify and/or accelerate the change (Siti-Nabiha and Scapens, 2005). Thus, institutions do change over time.

Next, we consider the theoretical frameworks developed by Van de Ven and Poole and Weick and Quinn. Van de Ven and Poole argue that process is a central component of their framework used to describe and explain organizational change. Alternatively, Weick and Quinn use the rhythm of change to evaluate organizational change. From both of these theoretical

frameworks, we are able to discern and evaluate the nature and properties of change organically and inorganically. Weick and Quinn provide us with a theoretical framework for Episodic and Continuous Change Processes, which focuses on the rate and cadence of change. While Van de Ven and Poole's framework emphasizes two distinct characteristics: the unit of change and the mode of change, the two frameworks are conjoined by the evolutionary motor-the link that binds them together. Weick and Quinn's analytical framework consists of three major components: inertia, the change trigger and replacement (See Table 1).

[INSERT TABLE 1 ABOUT HERE]

The institutional change process is more often than not considered evolutionary and influenced by existing institutions (Siti-Nabiha and Scapens, 2005). According to Hoffman (1999, p. 351), "The analysis of institutional evolution involves transactions among three aspects of institutions", which Scott (1995) referred to as pillars: regulative, normative and cognitive. For the purpose of this study, we focused on the regulative pillar. Hoffman argues that the byproduct of the regulative pillar in institutions is often regulation, stating that,

"Regulation often guides organizational action and perspectives by coercion or threat of legal sanctions...the institutional pillars are not analytically and operationally distinct, but rather overlapping, so that the development of one aspect will influence the development of the other aspects." (1999, p. 353).

Therefore, regulation serves as an external change stimulus to the organizational environment. As such, regulation is one way to institutionalize new norms, routines and practices, which can move the organization in either direction toward inertia or isomorphism (Hoffman, 1999).

Institutional (coercive) isomorphism can result when an organization is pressured or forced to comply because of some other requirements imposed by law or government, which

can have a major impact on the change process (Caccia and Steccolini, 2006). The source of the change process can be either internal, external stimuli or both.

Up to this point, we argued why the OIE component of institutional theory and the associated frameworks are well suited to anchor our theoretical foundation. However, there are some limitations. One major criticism of OIE is that it is not entirely clear how institutional change takes place. Ribeiro and Scapens (2006, p. 95) state that, "OIE does not identify the source of innovative change in the organization". A limitation of the Burns and Scapens (2000) framework is that it does not mention what causes change or innovation either. Van de Ven and Poole's (1995) framework classifies organizational change into four categories-- evolutionary, teleological, dialectical and life cycle. A concern with this framework is that it does not address the dynamic movement of organizational change to and from each category. Moreover, the organization is capable of possessing all category traits simultaneously or at different stages. Because change can be processual, there may be instances where the change observed could be both episodic and continuous in different phases and/or stages. Therefore, it raises the question of, how can new institutions emerge from institutionally embedded norms, routines and practices? Seo and Creed (2002) get closer to answering this question by suggesting that the sources for institutional change could potentially be revolutionary triggers or disruptive events.

Disruptive events have the power to disengage established routines, protocols and practices, thereby causing disequilibrium. Hoffman (1999, p. 353) states that, "disruptive events and crises in an inter-organizational field plays an important role in driving institutional change by thrusting social actors into periods of upheaval and bringing to a sudden end the

practices that had been locked in by institutional inertia.” Seo and Creed (2002, p. 234) add that, “revolutionary disruptions from the outside give rise to institutional contradictions, which facilitates shifts in existing social order through institutional crisis.” These disruptive events have been characterized as initiating events, shocks and/or triggers. Weick and Quinn, (1999, p. 369) argue that change triggers have the power to overcome strong inertial forces Huber *et al.* (1993) state that,

“Although inertia creates the tension that precedes episodic change, the actual triggers of change come from at least five sources: the environment, performance, characteristics of top managers, structure and strategy, which can originate from sources related to both internal and external changes” (p. 223).

Thus, these triggers can serve not only as a catalyst to establish a new steady state, but they serve as a way to explain the change process on various organizational levels (Hoffman 1999).

Despite the limitations of existing frameworks, they do provide a foundation for new concepts to be developed. The key contribution of our study is the creation of the new Two-Tiered Organizational Change Framework because it draws upon the work of Burns and Scapens (2000), Seo and Creed (2002), Rebeiro and Scapens (2006), Van de Ven and Poole (1995) and Weick and Quinn (1999). The new Two-Tiered Organizational Change Framework addresses the questions of why, when and how change occurs within organizations.

Based upon the combination of specific parts of these prior studies, a new theoretical framework emerges with two dimensions (see Figure 1). We believe this new framework allows us to explain and analyze organizational change as a process through the IAF.

[INSERT FIGURE 1 ABOUT HERE]

In Figure 1, the first dimension is depicted as episodic versus continuous change. The second dimension is portrayed as evolutionary versus teleological. Episodic change represents a divergence from the status quo. Typically there are triggers that spur this type of change. For example, the terrorist attack of 9/11 was a major shock that completely disrupted our national security. From that day forward, the U.S. government's views and treatment of national security issues has changed dramatically; it can be seen as a revolutionary change. Thus, it is unlikely that the U.S. will revert back to its prior national security methods. In contrast, continuous change is seen in small increments over time. Thus, change is viewed as repeated modifications and emergent patterns. We see that change can be both episodic and continuous, and it can be categorized as evolutionary or teleological. Hence, there is a relationship that exists between the two dimensions. Each quadrant has a specific descriptor that characterizes the phenomenon associated with the change.

Quadrant 1 uses the descriptor of "events", and is bounded by evolutionary and episodic change. According to Seo and Creed (2002), the source of change can serve as revolutionary triggers or disruptive events. These disruptive events have the capability to break the stronghold of inertia by halting or altering the course of established routines and practices that were institutionalized (Hoffman, 1999; Seo and Creed, 2002). Hoffman (1999) would characterize the occurrence of accounting and corporate fraud scandals at the beginning of the millennium as initiating events in quadrant 1 "Events" category of the Two-Tiered Organizational Change Conceptual Model (Figure 1).

Quadrant 2 uses the descriptor of "Behavioral Response", what is the outcome or reaction? This category is bounded by teleological and episodic change. Whenever

organizations and/or organisms in the environment are exposed to stimuli, there is a behavioral response. Therefore, organizations in quadrant 2 (Behavioral Response) who comply with the Sarbanes-Oxley Act (SOX) are motivated by what is referred to as coercive isomorphism (Caccia and Steccolini, 2005). With regard to the IAF, the shift in roles and responsibilities would occur in quadrant 2 where the IAF takes the lead in corporate governance by helping organizations become compliant. Sometimes change is unexpectedly thrust upon organizations and their response is considered reactionary. Given that there is a new pecking order, organizations strategically plan how they are going to accommodate this new change.

Quadrant 3 uses the descriptor of “goal/strategy; it is bounded by teleological and continuous change. This particular category speaks directly to the questions that OIE researchers pose. How can new institutions emerge? Seo and Creed (2002) tell us that revolutionary change triggers are a source for the introduction of new rules, routines and practices. Since these change triggers have the power to overcome inertia (Quadrant 4), organizations can establish new goals and strategies to address opportunities and threats. We observe that each of the categories in this conceptual model is not mutually exclusive; there is an interdependence that exists among each of the categories. Hoffman (1999, p. 353) states that, “the institutional pillars are not analytically and operationally distinct but rather, overlapping, so that the development of one aspect will influence the development of other aspects”. The same can be said of the Two-Tiered Organizational Change Conceptual Model. Thus, the model is useful for helping us explain the transitional process that the IAF went through as a result of SOX.

Quadrant 4 uses the descriptor of “gradualism”; this category is bounded by evolutionary and continuous change. Gradualism is an evolutionary concept that explains change as a gradual process or change in small increments. It is in this category that organizational rules, norms and practices are institutionalized (Burns and Scapens, 2000), which because they are intertwined with day to day activities. Deeply embedded norms make it difficult for organizations to move or act; it takes major disruptive events to move them from one category to the next. Consequently, this category is where the IAF of many organizations were prior to SOX; they were stuck in a holding pattern.

In brief, this new, Two-Tiered Organizational Change Framework makes it possible to answer the unanswered questions that previous OIE researchers posed of how and why institutional change occurs as a process within organizations.

Research Question

How does the environmental change factor of regulation bring about a shift in the Internal Audit Function’s Role in the organization post SOX?

Methodology

The case study method was chosen because it gives an opportunity to explore the rich insights from key people in the internal audit function. A multiple case study research design provides a deep-seated perspective about the key paradigm shift in the internal audit function as result of SOX.

The empirical analysis of this study was based on information obtained about the internal audit functions of business firms located in the United States between June and August of 2012. The primary method of data collection was semi-structured personal interviews) with

Chief Audit Executives (CAEs) of small, medium and large public companies, senior management, audit committees and board members. There were eight interviews conducted with members from organizations that were primarily public, but a governmental entity and a privately held firm were included as well. The interviews lasted 60 to 75 minutes, and were recorded. At the conclusion of each interview, participants were forwarded a copy of the case study report summarizing the responses.

The analytic strategy consisted of two phases. In the pre-analysis phase, all interviews were transcribed verbatim and handwritten field notes were summarized. In the second phase, a coding scheme was derived and analyzed further. Public domain information about the organization and other documentation provided by the participants were used to triangulate the data.

Results

Organization 1

Organization 1 is a large cap international industrial conglomerate in several industry sectors: industrial machinery, energy and communications with 100,000+ employees. After the SOX Act became effective, the response was the marshalling of resources to ensure the organization became compliant. The audit committee member stated that, “the most obvious thing that sticks out is that we had to divert more resources for SOX compliance in terms of the hours spent by the internal audit function needed to document all of the control points”. SOX was a catalyst for raising the broader risk concerns facing the organization.

“Enterprise risk management (ERM) was not very good in most organizations because it was very broad, and there was not a lot of guidance about how to

implement it effectively, but I would have to say that SOX gave a new impetus to ERM that we did not have before.”

The board received many dashboards that highlighted areas in internal control that the organization needed to improve. However, those reports did not always prove reliable.

“The board received what is called red, yellow, green light heat charts; these charts lull you to sleep because you tend to look at what management and internal audit says is red and how we are mitigating it. But, if you go back in time to the financial crisis of 2008, we soon discovered that a lot of what went wrong was in the green category. As a result, the audit committee decided to form a new habit by selecting a green items for the IAF to provide evidence that the controls and risk concerns are indeed operating well.”

The IAF’s role became much more important because it had risk management and internal control expertise, which could be leveraged to help the organization become compliant.

“Don’t get me wrong – it is not the IAF was not important before – it always was. But, I think the IAF’s role was heightened because it could not afford to drop the ball on this process.”

Moreover, SOX did not allow for the organization to settle for an ineffective IAF.

“I think SOX put a whole new dimension around the chief internal auditor so much so that she has to be more on her toes than ever before to make sure the organization has the right people.”

Thus, SOX motivated CAEs to bring on adequately trained and competent people into the IAF.

“Individuals that are properly recruited, trained and developed can be elevated to junior management positions.”

Prior to SOX, the IAF was not considered a valuable resource.

“The IAF in older days became a reservoir of operating people who weren’t seen as tremendously valuable with the operations, so, they would stick them over there in internal audit so they would not be over here in operations.”

High performing, properly trained internal audit team members are considered ideal candidates for other roles in the organization.

“The organization has to have a process in place and the support of senior management that we are going to use the IAF as a training ground to develop some of our high potential people to go into positions of increasing responsibility in the organization.”

Analysis of Organization 1

Organization1 was in quadrant 4 (gradualism) prior to SOX. After the disruptive events (quadrant 1) like the accounting and corporate fraud scandals occurred, the organization's behavioral response (quadrant 2) was the diversion of resources. Another behavioral response outcome related to the SOX legislation was the renewed focus on ERM. Here, the organization is institutionalizing new norms and practices based on the environmental stimulus called regulation. This reaction would fall into quadrant 2 (behavioral response) and quadrant 3 (strategy/goal). These actions are significant because we see the initial response being characterized as episodic. Then, there is a teleological change with regard to how the organization addresses the enterprise risks going forward on a continuous basis. Careful evaluation of the audit committee member's response gives rise to another disruptive event (quadrant 1) that triggered a response (quadrant 2) when he says, “Based on the financial crisis of 2008 ...” This change trigger was an environmental stimulus that broke through the inertia of established norms and practices (i.e., only focusing on the red indicators on the heat chart) by establishing a new strategy (quadrant 3). This new strategy allowed greater assurance that internal controls are effective and the risks were being adequately addressed. From the perspective of quadrant 2 (behavioral response), it is reasonable to discern that SOX likely motivated the IAF to ensure that adequately trained and competent people were added to the IAF. Thus, we see the IAF moves through various stages and categories of the new Two-Tiered Organizational Change Conceptual Model. We are able to observe how new practices and

routines have been institutionalized as a result of the regulative pillar triggered from the disruptive scandal events.

Organization 2

Organization 2 is a publicly traded international consumer products company with 100,000+ employees. SOX changed the scope of the IAF's work to focus more on financial reporting controls. The CAE stated that, "because there is also a statutory requirement with SOX, sixty percent of our time is spent on financial control and SOX related stuff." The purpose of the SOX Act was intended to drive and change behavior; the impact was manifested in various ways.

"SOX clearly defined and formalized accountability for the CEO and CFO through the certification process. Also, excessive testing of the base-level controls caused the IAF to lose focus on the broader set of risks that the company was facing."

New norms were established as a result of SOX with regard to ERM and a shift in audit strategy.

"Practices regarding ERM changed to increasing the level of documentation, implementing a stronger sub-certification process and creating a disclosure committee. Also, after five years of SOX being in place, the IAF began to focus on other risk areas and opportunities as well as adjust audit approach."

Even though SOX created major changes in the IAF, some were evolutionary because the organization was not aware of the IAF's worth and value.

"The IAF has taken a leadership role, but it was not necessarily because of SOX. SOX sort of put the IAF in a box. If anything, SOX made the IAF's job more difficult. However, I will concede that SOX did open the door and heightened the awareness of the other things the IAF can do that can add value."

Lastly, the organization can reap the value of the IAF as a developmental function for successful business leaders.

“The IAF serves as pipeline for new talent. Candidates have the opportunity to see many different parts of the business. As such, we developed rotational programs to develop future business leaders. Not to mention, half of the top finance leadership are alums of the IAF.

Analysis of Organization 2

Organization 2’s behavioral response (quadrant 2) to SOX was the significant amount of time spent on SOX-related; this action speaks to the operational execution of the compliance effort by the IAF. This represented a significant departure from the established norms and protocols of the organization’s activities. Not to mention, established new norms and practices with regard to ERM and audit strategy (quadrant 3). However, the CAE argued that some of the change was evolutionary (near quadrant 4) because it was not all because of SOX. It can be argued that SOX brought awareness to senior management about the value that the IAF brings to the table and the skill set comprising its competency. The IAF proved its mettle by demonstrating its leadership ability in corporate governance. Therefore, it is not surprising that using the IAF as a development function to develop new business leaders through rotational programs has become an institutionalized practice (quadrant 3) in many organizations.

Organization 3

Organization 3 is a state university system with 40,000+ employees. This government entity has an audit committee that governs the IAF. Although they are not subject directly to SOX, it had an impact on the compliance effort of the IAF. One CAE remarked that, “I think what it has done is it has raised the risk profile and expectation of the IAF because the federal signoffs are very similar to SOX certification and attestation.” According to the CAE,

“The profile and expectations of IAF have increased significantly, and I think a large part of that is a lot of the folks on our board come from a private sector

background; therefore, they tend to ask some of the same questions in their business.”

The CAE also suggested that the focus of the IAF evolved as an offshoot of SOX.

“Some of the change can be described as evolutionary because our stakeholders demanded wider degree of assurance. SOX was very focused on financial statements and internal control. To a governmental agency, it translates into the IAF looking at things beyond the traditional financial stuff, but getting into other areas like getting more into IT.”

SOX changed the scope of the IAF’s work from compliance to an advisory role. The CAE states that, “roughly 30 % of our audit schedule is dedicated to consulting engagements”. This action represents not only a change in routines and practices, but a shift in strategy and goals of the IAF in terms of providing value and assurance going forward. The work of the IAF is more than just providing reports; they partner with the organization by disseminating critical information without compromising its fiduciary responsibilities.

“One perception – and I hope reality – is that the internal audit brings a level of integrity to whatever they do, even if they are no longer in an internal audit role; they are used to speaking truth to power and finding a way to communicate what needs to be communicated and what is important without being offensive.”

Internal audit experience is a competency that equips auditors to become successful leaders in different roles.

“Auditors take the knowledge they learned to roles of increasing responsibility in the organization such as Chief Business Officer (CBO), Chief Financial Officer (CFO) and Director of IT Audit and other cross-functional roles.”

Analysis of Organization 3

Organization 3 was in quadrant 4 prior to the passage of SOX, even though it was a governmental entity. The implications of SOX could be felt directly as a behavioral response (quadrant 2), and many of their established norms, practices and routines were altered

accordingly. This change came about because those oversight individuals were directly from or had close ties to the private sector. Some of the changes that occurred from an assurance perspective was evolutionary because the regulatory environment was changing and the stakeholders demanded more from the assurance providers. The board of regents were looking for assurance updates indicating that the resources entrusted to its authority were properly accounted for and used in accordance with the intended purposes. Thus, SOX has had an indirect impact on the compliance update for the board of regents. From the perspective of the CAE, the scope of the IAF's role and strategy (quadrant 3) had shifted to an advisory capacity as evidenced by the change in consulting engagements.

Organization 4

Organization 4 is a large cap privately held manufacturing and consumer products company with 60,000+ employees; it was publicly traded for many years before becoming privately held. According to the CAE, the IAF is a key player in helping the organization achieve its goals and objectives as part of a robust three-prong defense model called 'Three Lines of Defense Model'.

"The first line of defense is management saying we are going to ensure that the right actions take place to achieve the objectives; the second line of defense is internal assurance providers, which could consists of a compliance group, a quality assurance function and a controllers organization have a role in providing monitoring and assessment; the third line of defense is internal audit."

This defense model provides assurance and fosters value creation in the organization.

"In our organization, one of our key guiding principles is around value creation. Since the IAF does not come up with new product lines, we don't necessarily find new customer segments, but I think we create value in two ways; specifically, I define value creation as protecting existing value by ensuring that good effective controls are in place and operating effectively. Secondly, by providing

engagement reviews, we enable new value to be created in the organization – that is our contribution.”

Because of SOX, the IAF received more funding and attention.

“The legislation actually brought a tremendous amount of focus and funding to internal audit from a value protection standpoint which is very good, but I think it also forced a diversion of resources away from other risk areas. However, I think from a senior executive standpoint, SOX was designed with good intentions, but now, the IAF was still spending more time than we would like on SOX activities.”

There were positive residual benefits from SOX.

“First, it brought more attention to the value of internal auditing. Secondly, the profession and most internal audit departments do better job of understanding risk and risk assessment in their organization. Thirdly, it helped us realize that no matter how much management may value other types of activities, we always need to have the fiduciary responsibility to do a certain amount of blocking and tackling. What I mean by that is if you look at it from a pendulum standpoint, I think in the late 1990s through the early 2000s the pendulum swung too far away from internal controls to justify existence. With the passage of SOX, the pendulum swung too far the other way, and I think we are moving toward equilibrium now.”

SOX was a catalyst for structural change in the organization.

“The structure changed at the time because it needed to change; there was greater emphasis on people who have financial reporting and controls backgrounds both in auditing and internal control, which created temporary demand for that expertise. As time passed, the structure has started to morph back into the organization eliminating the need for separate SOX group office in many instances.”

Internal audit was able to move into the consulting role to a certain extent.

“There is probably a consulting role around how do we rationalize these controls or where we have too many controls; thus, maybe there is a way to make SOX more efficient. I think internal audit played a pretty important consulting role there. I wouldn’t say that the IAF truly has a seat at the table, but you are integrated enough in that you can provide advice, you can provide caution, you can provide risk insights for decisions that still are going to be made by somebody else. I hear people saying that you can have a seat at the table, but when it comes to vote, you don’t have a vote. Either way, the IAF has to be

careful not to take on a management role because it will impair independence and objectivity.”

Internal audit experience can add value to the organization in a number of ways.

“The way internal auditors are trained to think can be valuable to the organization. For example, rotational models are becoming trendy because people are taught to think about risk and control, which raises their risk knowledge and expertise. The organization deploys these individuals throughout the organization in various functions. Then, you will ultimately get a stronger control environment because these individuals have a control and risk orientation.”

Internal audit experience can be used as a competency for new business leaders.

“I think internal audit experience still trains people to think in such a way that if they have strong interpersonal skills they have the requisite tools to become effective business leaders.”

“Part of our vision in internal audit is to be a pipeline of people with the right virtue and talents into the organization; I keep telling the rest of the management team while it is important to help everybody strengthen his/her audit skills, our primary objective is to coach them to be better business people – not just better auditors. Therefore, if we recruit high potential candidates, give them good opportunities and coach them right, I think we put them in a great position to move out of internal audit and then up into the organization.”

Analysis of Organization 4

Organization 4’s behavioral response (quadrant 2) to the environmental change factor of regulation was an inordinate amount of time being spent on SOX activities. Those disruptive events (quadrant 1) created episodic change. Previous practices were at one end of the spectrum leaving them locked into a holding pattern with small increments of change taking place (quadrant 4). After the regulative pillar of SOX disrupted their equilibrium, a new steady state was established. This new steady state brought with it the implementation of new practices (teleological change) and strategies (quadrant 3) that were institutionalized going forward.

Due to the demands from the regulatory environment, the IAF responded by becoming an advisor/consultant. We observe the behavioral response (quadrant 2) from the organization to address enterprise risk concerns using a coordinated effort from other assurance providers. This action would fall under quadrant 3 (strategy/goal). Additionally, management implemented a plan to develop future business leaders using the rotational program. Thus, this action is institutionalizing a new norm, practice and/or routine.

Organization 5

Organization 5 is a publicly traded, small cap services and retail logistics company with 1,700+ employees. In this company, SOX served as a training opportunity.

“SOX was a tool to re-educate the board on its corporate governance responsibilities as well as develop a framework to re-define the organization’s operating strategy.”

SOX shifted the role and responsibility of the IAF.

“Before SOX, I viewed our IAF as more of a consultant. Once SOX took effect, it created a governmental agency (Public Company Accounting Oversight Board-PCAOB) and swung the pendulum from the IAF being an operational consultant with an operational viewpoint to the role of a compliance and regulatory checker.”

The IAF added value by being proactive in corporate governance and developing relationships.

“Our IAF added value by establishing best practices, helping management and the audit committee understand its role in corporate governance and facilitating actions that help the organization remain compliant. One way that our IAF demonstrated leadership was to establish relationships using a collaborative approach. This is how we are able to gain respect and facilitate value.”

SOX helps to emphasize the value of internal audit experience.

“I am a firm believer that everyone in my department who has gained internal audit experience is well positioned to secure other leadership positions in the

organization. SOX did help to elevate the status of the IAF and bring awareness to senior management and the audit committee about what the IAF can do.”

Analysis of Organization 5

Organization 5’s initial response (quadrant 2) to SOX was a shift in responsibilities from being an operational consultant to becoming a compliance checker. The audit committee must know where the organization stands in terms of readiness to meet its compliance objectives. An advantage of SOX was that it allowed the organization to institutionalize a new norm and practice by re-setting the organization’s operating strategy (quadrant 3).

Organization 6

Organization 6 is a large cap publicly traded firm that operates in the power generation and energy business with 26,000+ employees. According to the CAE, SOX had an impact on the organization, but not like most organizations.

“This organization decided not to treat SOX as a bolt on. It was merely another compliance directive that was added to the list. Many of the SOX requirements were already a part of our organization’s daily responsibilities and routines. The key impact on our business is that it forced an awareness of issues and circumstances at a much more granular level in the business than had ever been contemplated before in most organizations.”

The IAF provided additional value as a result of SOX.

“Part of the value we bring is continually challenging management to refine its portfolio of key control activities regardless of the type of audits (i.e., compliance, operational or financial) conducted. We do the work with a point of view or a lens toward effectiveness and efficiency of controls and process.”

SOX changes perceptions about the value of internal audit experience.

“I think the view of internal auditing has evolved greatly in that the view of IAF was perceived as a leader of the SOX implementation; this view drove expectations, challenged the status quo and pushed management to do better. Now, I think the point of view or the impression of internal auditing is we are a monitoring function of management’s self-assessment process. With this

approach, it frees up a lot of time for the IAF to do some pointed compliance work as well as some targeted consulting and process improvement work, which I think is more ideal.”

Results are mixed as to whether senior management seeks advice from the IAF on other business matters.

“I don’t believe this view is universal, but I think it is more prevalent in organizations where a positive relationship exists with management. Thus, the key is relationships. If we have good relationships with management executives, then they are more likely to ask the IAF’s view on things.”

Internal audit experience proves to be valuable to the company from a development perspective.

“An example would be the GE model of using corporate audit to learn more about the business. I would advocate taking what we call a high potential candidate early in his career or mid-level career and put him in an internal audit role for maybe eighteen months to three years and have him touch all of the different businesses in the company. The candidates would learn about the business and then get into the mindset of being enterprise risk, governance and controls oriented. And then, the candidates are sent out into the business with this mentality to advance their careers. Hopefully, this approach will continue to raise the bar in terms of a stronger control environment in the organization.”

Analysis of Organization 6

Organization 6’s response was not as dramatic because many of the SOX requirements were already institutionalized. Therefore, the audit committee viewed the IAF as driving the compliance effort and providing it with an assurance update. SOX compliance was just a normal part of doing business because the infrastructure for regulatory compliance and other corporate governance matters was already in place.

The organization is exercising a new strategy/goal (quadrant 3) of using the rotational program of leveraging internal audit experience to develop future business leaders as well as strengthen the overall control environment.

Organization 7

Organization 7 is a small cap publicly traded telecommunication and technology company with 1,500+ employees. SOX had an impact on several areas, including corporate governance, internal audit, enterprise risk and financial reporting.

“The resources and the quality of talent involved in the IAF has increased as a direct result of SOX and the subsequent pronouncements by the SEC involving various aspects of financial reporting. The impact has been both positive and negative. For example, I think there is more assessment and evaluation today than the pre-SOX period. Another impact has been the rethinking of audit’s role in terms of internal control. In other words, there is dual validation that the controls are effective by the IAF and the external auditor. Another outcome of SOX is that it added formality and accountability to the financial reporting routine.”

“As a result of SOX, there is lot more rule-making around off balance sheet activity, evaluations of acquisitions and lease accounting to create more openness and transparency to assess the true status of the financial health of the company. I think it has to a certain extent lessened the degree of aggressive accounting.”

SOX had an impact on the quality of talent in the IAF.

“SOX definitely put the spotlight on upgrading the quality of talent in the IAF in terms of technical training, experience and certification.”

SOX made an impact on ERM and the structure within the organization.

“I believe the SOX kicked off the discussion around ERM. Eventually, audit firms and the boards recognized that they needed to open the conversation around the question of business risks that firms were facing. Clearly, SOX has ignited the debate about enterprise risks. So, if companies did not have an enterprise risk management system in place, they either started one or improved the one they had.”

Lastly, the organization sees the value of leveraging internal audit experience.

“A number of companies strongly encourage and maybe even require senior level executives to spend some time in the IAF. Consequently, members of the IAF compete for cross-functional roles, which leads to audit people going into business roles and business people spending time in the audit role.”

Analysis of Organization 7

The CAE's response (Quadrant 2) to SOX legislation was to upgrade the talent in the IAF. The audit committee's view is based on organizational readiness to meet the compliance objectives. Where do we stand? Are we on track to meet these objectives? What resources do we need to mobilize in order to hit our compliance targets? The IAF should serve as a liaison and provide the audit committee with an assurance update. As an ongoing strategy (quadrant 3), the organization established a practice of monitoring the other business risks.

Organization 8

Organization 8 is a large cap publicly traded telecommunications company with 250,000+ employees. According to the CFO, SOX made an impact to the IAF in terms of their reporting structure.

"The IAF now reports directly to the audit committee in many instances as opposed to the CFO in many organizations. However, I do not believe that SOX has changed perceptions about the IAF. The IAF is not a business partner they are the cops in the organization."

"The IAF in my organization is not included in the decision making process for the most part except it may wield a little power to influence management to consider or pass on a project because of the risk factors and organizational readiness. Aside from that, the IAF is still the watchdog. A negative report from the IAF could potentially have career ending implications."

Lastly, internal audit experience can be valuable if it is combined with successful business leadership qualities.

"The IAF can serve as a good proving ground for successful business leaders if it is not too consumed with the rigidity of internal audit. But, by incorporating the tools learned to exploit the opportunities available to the organization, members of the IAF can make the leap. Thus, I think individuals who have internal audit experience will be successful in other roles in the organization if they have the interpersonal skills and personality to build relationships."

Analysis of Organization 8

One of the most significant changes from the audit committee's perspective is the change in the reporting relationship as a result of SOX. Organization 8's behavioral response is captured in quadrant 2. Historically, the IAF reported to the CFO, but now it reports to the audit committee. In addition, the audit committee views the IAF's role as that of a leader in executing the organization's compliance effort. Another key change is the formal documentation for internal controls and financial reporting. Also, SOX required that there be at least one financial expert on the audit committee. Because of the new requirements in terms of accountability and transparency, some board members chose to leave, which gave rise to vacancies.

The CFO does not believe SOX has altered how the IAF is viewed in the organization, but he believes it can be most effective when it has the ability to use its risk management expertise and disseminate best practices.

"...I do not believe that SOX has changed perceptions or the role of the IAF – they are still the cops in the organizations."

"The IAF can serve as a good proving ground if members are not too rigid." He claims that, "internal audit candidates can use their know-how to make the transition to business leader if they have the interpersonal skills to build relationships."

Even though some senior managers do not see a material departure from the traditional, fiduciary obligations of internal audit in terms of safeguarding assets, procedure enforcement and risk assessment, there is a consensus that the skill set is beneficial to the organization in a number of ways if combined with the right interpersonal skills.

Discussion

In each of the eight cases there were similarities driven by SOX. In organizations 1, 2 and 7, there was significant emphasis placed on ERM. There were major resources devoted to SOX compliance. SOX played a key role in raising the importance of the IAF; this was a common thread in organizations 1, 4, 5 and 6. A major response from organizations (1, 7) was the increased focus placed on bringing talented people into the IAF who were adequately trained. It was noted that the IAF could add value by communicating critical information and sharing best practices. For many organizations (3, 4, 5 and possibly 6) SOX was a catalyst for shifting the role of the IAF from procedure enforcement to that of management advisor and/or consultant. Moreover, there was the shared belief that there was merit in leveraging internal audit experience as a competency tool. Another common thread was targeting high performing candidates to participate in rotational programs, which is a contemporary trend in developing future business leaders for the organization. In organizations 4, 5 and 8, strong interpersonal skills along with the ability to establish relationships was a formula for success in terms of leadership development and securing positions of increasing responsibility outside of internal audit.

Despite the many similarities, there were notable differences. Organization 5 was an anomaly because most organizations were gravitating toward the consultant/advisor role, but they were already there and was forced to shift to the polar opposite position. Organization 6 already had many of the SOX activities ingrained into their daily regimen. Organizations (5, 7, 8 and maybe 6) viewed the IAF's transition into the role of management advisor/consultant with mixed concern. Specifically, organization 7, shared that this role was not standard practice, and

suggested that some organizations embraced this view of IAF as a management advisor/consultant if a positive relationship existed with senior management. Lastly, the CFO of organization 8 shared that he did not see the IAF as a management advisor or consultant except to provide due diligence on a specific project. Other than that, he saw no change in the role of the IAF.

In brief, the IAF prior to SOX was in the “gradualism” category; it was evolving slowly over time. Factors such as technology, emerging risk concerns and the changing demands of the business have played a key role in the evolution of the IAF in terms of the audit approach strategy and scope of work. But, it is extremely difficult to deny that major corporate governance reform legislation did not have an impact on the IAF. It can be argued that regulation served as a catalyst to establish a new steady state by creating an environment of stable change.

The two-tiered organizational framework extends the previous work on the substance of organizational change (Burns, 2000; Burns and Baldvinsdottir, 2005; Burns and Scapens, 2000; Ribeiro and Scapens, 2006). This previous work is useful for explaining change as a process within organizations in the midst of existing protocols and routines that are already embedded or institutionalized (Burns and Baldvinsdottir, 2005; Burns and Scapens, 2000; Siti-Nabiha and Scapens, 2005). The two-tiered framework goes further by explaining how and why new institutions emerge (i.e., the act of institutionalizing new practices, norms and routines). Further, the two-tiered framework is specifically geared for explaining strategic changes in organizational functions by addressing the recent dramatic change in the IAF.

This study also confirms previous work conducted using the Old Institutional Economics (OIE) component of institutional theory to evaluate the process of implementing a management accounting change (Burns and Baldvinsdottir, 2005; Burns and Scapens, 2000; Siti-Nabiha and Scapens, 2005). The findings are consistent with the findings of the aforementioned studies regarding the change in existing practices and norms and the shifting roles and responsibilities as a result of the management accounting change. Moreover, this study applied the same methodological approach to evaluate the impact of SOX (corporate governance legislation) on the internal audit function in eight organizations that vary in size, scope and nature of goods and services provided.

The two-tiered organizational change framework offers an alternative view of organizational change to that represented in previous research (Siti-Nabiha and Scapens, 2005).

The previous work, conducted on stability and change under the New Institutional Sociology (NIS) component of institutional theory, found that the organizational response to external pressure resulted in decoupling as a by-product of resistance to a change in management accounting. According to this work, such a response allowed organizational actors to comply with the letter of the change but not the spirit. In other words, the full impact of the change was not realized in the day-to-day activities because of the conflict with existing norms, practices and routines.

In contrast, the two-tiered organizational framework suggests that the impact of external pressure (e.g., SOX regulation) is part of the dynamic cycle of change in which change triggers elicit a behavioral response. These change triggers/shocks reveal how new institutions

emerge through the creation of new norms, protocols and/or modification of existing practices and routines.

Although the views differ, they share the same conceptual foundation in institutional theory. Further research that builds on this link will create fertile ground for advancing our understanding of how external change factors drive change within the organization.

Conclusion

We have seen a dramatic paradigm shift in the evolution of the internal audit function. Thus, this study sought to answer the question, “How does the environmental change factor of regulation bring about a shift in the Internal Audit Function’s role in the organization post-SOX? A series of exogenous shocks set into motion a cascading chain of events that produced fundamental, revolutionary changes in corporate governance (i.e., SOX) and in the IAF. The introduction of a two-tiered organizational change conceptual model shows us how events, response and strategy are key parts that drive change in the organization and its functions. SOX sparked evolutionary changes in the roles and responsibilities of the IAF. As a result, new processes were changed and redesigned to strengthen the internal control environment to promote efficiency and improve overall effectiveness. These actions paved the way for the IAF to transform itself. Thus, SOX served as a catalytic agent, which brought awareness about the value of internal audit experience to many organizations and its senior leaders.

Contribution

This study makes two critical contributions to theory and practice. First, it introduces a new, two-tiered organizational framework, which allows us to analyze nature and substance of organizational change in the IAF; this is accomplished by using a two-dimensional approach to

categorize change as being episodic versus continuous change and evolutionary versus teleological change. This two-dimensional framework classifies the change into specific categories: events, behavioral response, strategy/goal and gradualism. Further, the two-tiered organizational framework goes on to show us movement up and down each continuum. We learned that change is not order-specific and static; it can serve as a behavioral response to a teleological change in one sense and become a change trigger in another category or quadrant.

Secondly, this study contributes to practice by providing managers with a strategic plan to successfully address change. When serious governance legislation arises, the organization needs to consider the realignment of its functions, processes and/or structures. Legislation has the power to challenge existing institutional norms and protocols already embedded in the organization to be modified and/or deleted, while allowing new practices and routines to be institutionalized. Instead of dwelling on the negative aspects of this organizational change, managers should treat this as a change management initiative that can be used as an opportunity to unload ineffective and inefficient practices. Managers can re-evaluate structures and implement process improvement measures that will allow them to achieve operational efficiency, which can lead to enhanced profitability. Managers can do this by applying the ten principles of change management; the change management steps are addressing the human side, starting at the top, involving every layer, making the formal case, creating ownership, communicating the message, assessing the cultural landscape, addressing the culture explicitly, preparing for the unexpected and speaking to individuals (Jones, Aguirre and Calderone, 2014).

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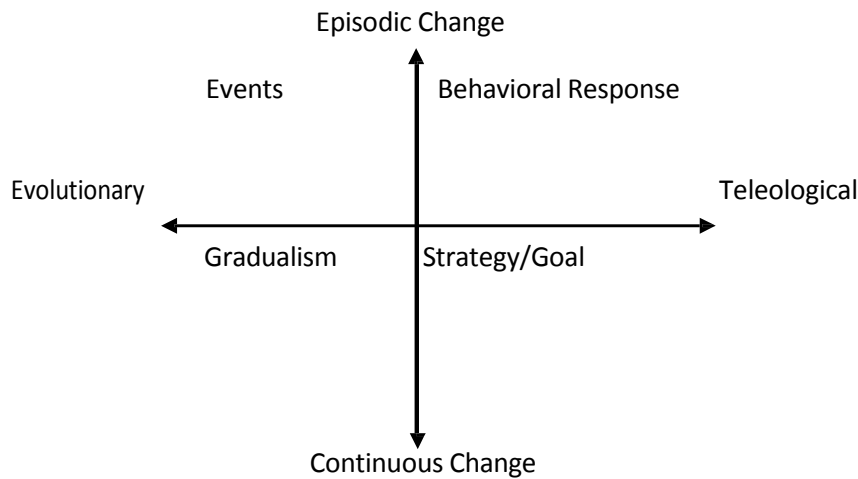
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Figure 1

Conceptual Model of Two-Tiered Organizational Change Framework



Note: Figure 1 is a Conceptual Model of a Two-Tiered Organizational Change Framework. This figure represents the intellectual contribution of this study. The model facilitates the analysis of organizational change in the internal audit function (and other functions) as a multi-dimensional concept (episodic-continuous vs. evolutionary vs. teleological) that possesses layers. Moreover, this framework illustrates that change is not order-specific and static, but it can be expressed in different outcomes (quadrant 1- events, quadrant 2- behavioral response, quadrant 3 –strategy/goal, quadrant 4 - gradualism) as it moves across each dimension. For example, it can serve as a behavioral response outcome in one sense and serve as a change trigger to produce another outcome.

Table 1

	Episodic Change	Continuous Change
Metaphor of the Organization	Organizations are inert and change is discontinuous and infrequent	Organizations are emergent and change is constantly evolving and cumulative
Analytical Framework	Change is an interruption or divergence from equilibrium; externally driven Perspective: macro, distant, global Emphasis: short-run adaptation Key Concepts: inertia, deep structure of interrelated parts, triggering, replacement and substitution, discontinuity and revolution	Change is a pattern or repeated modifications in work processes and practices; change is driven by organizational instability and alert reactions to regular contingencies Perspective: micro, local, close Emphasis: long-run adaptation Key Concepts: recurring interactions, emergent patterns, translation and learning
Role of Change Agent	Role: prime mover who creates change Process: focus on inertia and seeks points of central leverage Change meaning systems: communicates alternative schema, reinterprets revolutionary triggers, influence punctuations, builds coordination and commitment	Role: sense maker who redirects change Process: recognizes, reframes current patterns; shows how intentional change can be made at the margins, alters meaning by new language, dialogue, identity; unblocks improvisation, translation and learning

Note: Table 1 represents Weick and Quinn’s Analytical Framework for organizational change. Components of this framework were used to develop the Two-Tiered Organizational Change Framework, which helps to illustrate that organizational change is sporadic, nonlinear and multi-directional.