PERSPECTIVES ON THE INTERNAL AUDIT FUNCTION

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Abstract

Internal audit departments have become an important part of organizational structure as a value adding service and a very crucial instrument of management control. The importance of internal audits has been confirmed in a variety of legislation such as the Sarbanes Oxley Act (2002) in the USA. The recent spate of corporate collapses and financial scandals has resulted in an increased focus on internal auditing as an important consideration for organizations. The basic role of internal auditing is to help management achieve company goals. It also provides assurance that management has implemented a satisfactory internal control system to prevent risks. In addition, internal auditing should provide internal consulting services to all levels of the organization in terms of training, advices, facilitation and counsels. Nonetheless, to date, there has been scant research conducted on Internal Audit (IA) effectiveness. Prior IA research also has, for the most part, focussed on developed countries. Accordingly, internal audit appears generally, and IA effectiveness specifically, to be under-researched particularly in the context of developing countries. The increasing globalization of the world economy and the adoption of the International Monetary Fund (IMF) and World Bank-led economic reforms are factors now driving the surging interest in corporate governance practices in several developing countries. Therefore, it is important to understand internal audit practices in these environments. Apart from contributing to the literature, studies on IA in developing countries could potentially provide a more holistic understanding of the nature, context and processes of internal audit.

1. INTRODUCTION

Internal audit (IA) departments have become an important part of organizational structure as a value adding service and a very crucial instrument of management control. The importance of internal audits has been confirmed in a variety of legislation such as the Sarbanes Oxley Act (2002) in the USA. The recent spate of corporate collapses and financial scandals has resulted in an increased focus on internal auditing as an important consideration for organizations. With the global financial crisis of 2008-2009, internal auditing becomes especially important in managements tool-kit for safeguarding the rate of return on capital and ensuring that capital is not wasted or devalued. The Institute of Internal Auditing (IIA, 1999) presented a broad definition of internal auditing as; "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes". The basic role of internal auditing is to help management achieve company goals. It also provides assurance that management has implemented a satisfactory internal control system to prevent risks. In addition, internal auditing should provide internal consulting services to all levels of the organization in terms of training, advices, facilitation and counsels (IIA, 2011).

Coram, Ferguson and Moroney (2008) in their view sees internal audits as consisting of all the measures taken by the organization for the purpose of; protecting its resources against waste, fraud and inefficiency; ensuring accuracy and reliability of accounting and operating data; ensuring compliance with the policies of the organization; evaluating the level of performance in all organizational units of the organization.

For internal audit function to be effective as a management tool for internal control, internal auditors should be at liberty to state their opinions without any bias or restrictions. Although complete independence is literally impossible because internal auditors are often organizational employees and not outsiders (Gay & Simnett 2007), an independent frame of mind is essential and internal auditors should have the ability to make tough recommendations without fear or favour. Sawyer (1988) also argues that internal auditors should be independent in order to perform their duties and should state their opinions freely without any bias or restrictions.

It suffices to note that traditionally, the internal audit function has had significant responsibility for examining and reporting internally on the integrity of the firm's accounting and financial reporting systems (Kwon & Banks 2004). However, in recent years the literature indicates that the role of the internal audit function has changed in response to shifts in global business practices. Such changes created opportunities for internal audit to provide consulting services to management and assist boards of directors to manage risk (Mihret, James & Mula 2010). Hass, Abdolmohammadi and Burnaby (2006) reviewed the American internal audit literature and established that the literature indicates a paradigm shift in the activities performed by internal auditors. They state that internal audit in the USA has shifted its orientation to a value-adding one. The authors highlight that before the enactment of the Sarbanes-Oxley Act (SOX) of 2002, internal audit services were focusing on detection rather than prevention. However, after the issuance of the Sarbanes-Oxley Act (2002), internal audit changed its emphasis to a compliance approach. A review of European internal audit literature by Allegrini et al (2006) and a review of the Asia Pacific internal audit literature by Carey, Subramaniam, & Ching (2006) generally confirm this paradigm shift. Ahmad and Taylor (2009) also explain that the internal audit role has changed through three major stages. The first transformation of internal auditing began in the 1940s. In this phase the role of internal auditing focused mainly on checking transaction and records. In the 1940s, the internal auditor was a partner in improving the business processes and creating greater wealth by continuously working with management to ensure policies and procedures were followed. Since the 1990s, internal auditing has become a value adding service to organizations including assisting organizations in the management of risk by using sophisticated risk modelling, statistical sampling, computer assisted audit techniques, and focusing on total quality management as part of the audit process. According to the Basle Committee on Banking Supervision (1998), this heightened interest in internal audits is as a result of significant losses incurred by several organizations. An analysis of the problems related to these losses indicates that they could probably have been avoided had the companies maintained effective internal audit systems. Such systems would have prevented or enabled earlier detection of the problems that led to the losses, thereby limiting damage to the organization.

2. LITERATURE REVIEW

2.1 The Concept of Internal Auditing

The Institute of Internal Auditing (IIA, 1999) presented a broad definition of internal auditing as; "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes". The Glossary to the IIA standards differentiate independent and objectivity concepts as; "Independence: The freedom from conditions that threaten objectivity or the appearance of objectivity, such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels."

Al-Twaijry, Brierley and Gwilliam (2003) explain that there are two benefits in having an internal audit department within organizations. First, it improves organizational operations and manages risk. Second, it helps an organization in the prevention and detection of mistakes or fraud, and the safeguarding of assets. However, in recent years the literature indicates that the role of the Internal Audit (IA) function has changed in response to shifts in global business practices. Such changes created opportunities for internal audit to provide consulting services to management and assist boards of directors to manage risk (Mihret, James & Mula 2010). Hass, Abdolmohammadi and Burnaby (2006) reviewed the American IA literature and established that the literature indicates a paradigm shift in the activities performed by internal auditors.

Therefore, the Institute of Internal Auditors (2011) now defines internal auditing as: an independent, objective assurance and consulting activity designed to add value and improve an organization‘s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes‘. It can be argued that this definition highlights two important issues. The first one is that internal auditors should be independent. Secondly, internal auditing is an appraisal function for the organization‘s activities to help staff and management in performing their duties and ensuring adequate internal control. According to this definition also, internal auditors should play a relevant role in evaluating and improving the effectiveness of the risk management process. The definition also presents both assurance and consulting activities as key components of the IA function.

Goodwin (2004) states that the new definition of internal auditing has shifted its focus on the IA function to add value by improving the operations of the organization and by evaluating and improving the effectiveness of the organization‘s risk management, control and governance processes. Therefore, the new definition of internal auditing has changed the role of internal auditors to a value added and consulting function to management.

2.2. INTERNAL AUDIT EFFECTIVENESS

There are two basic reasons why it is important to examine IA effectiveness. One is that it is an indication of the quality of performance and can describe whether or not the IA function is performing in a satisfactory manner. The second is that the examination can serve as a motivator for an individual or an organization to improve their performance. Mizrahi and Ness-Weisma (2007) maintain that, in general, there are two important tools for achieving managerial accountability in the policy-making process, namely, evaluation and auditing. Nonetheless, as explained earlier, to date very few academic studies have been conducted on IA effectiveness, and despite the general undercurrent in relation to an IA paradigm shift, research has provided mixed findings on IA effectiveness (Mihret, James & Mula 2010), and has assessed IA effectiveness differently.

For example, Al-Twaijry, Brierley and Gwilliam (2003) studied the development of IA in the Saudi Arabian corporate sector by using an institutional theory perspective, and taking a sample of 135 companies listed on the Saudi Stock 50 Exchange. Therefore, they used questionnaires and interviews to assess the extent of compliance of IA practices with ISPPIA in terms of quality of IA staff; quality of IA work; an appropriate corporate environment; and support of top management to examine IA effectiveness. The results of this study show that IA in the Saudi Arabian corporate sector is ineffective and it is not a value adding service to organizations.

Goodwin (2004) makes a comparison between the role of IA in the public and private sectors in Australia and New Zealand. The author highlights that while there is no requirement for private sectors in Australia and New Zealand to establish an internal audit department, the Australian Stock Exchange (ASX) encourages large companies to do so. However, the requirement to establish an IA function in the Australian public sector is not straightforward because of differing State legislation. On the other hand, within the public sector in New Zealand there is no requirement for IA function. The results suggest that internal auditors in the public sector are less likely to report to the chief of financial affairs than those in the private sector.

Mihret & Yismaw (2007) studied IA effectiveness in public sector higher educational institutions in Ethiopia. The study attempted to introduce a new perspective for evaluation of IA effectiveness by using a model which consisted of four potential factors which may impact on IA effectiveness, namely, IA quality, management support, organization setting and auditee attributes. The results indicate that IA is ineffective in terms of proficiency, planning, recommendations and limitations to the scope of work. Furthermore, the study revealed that audit quality and management support are the two most important factors influencing IA effectiveness respectively. These researchers also suggest a need for future research to fully understand IA effectiveness in the public sector by identifying other variables affecting IA effectiveness. Their study also focused solely on one public sector—higher educational institutions in Ethiopia.

Yee et al. (2008) studied the role and effectiveness of IA in Singapore. They studied the perception of Singaporean managers on IA practice. Specifically, they considered whether IA is viewed as a partner with management or as a watchdog for routine compliance mechanisms. In contrast to prior research, this study applied Marxist economic theory to the IA function. Furthermore, in contrast to Saudi Arabia (Al-Twaijry, Brierley & Gwilliam 2003) and Ethiopia (Mihret & Woldeyohannis 2008; Mihret & Yismaw 2007), Yee et al.'s (2008) overall findings were that (i) the IA function in Singapore is improving and has become an integral part of organizations' structures as a value adding service; (ii) in general, managers are satisfied with IA; and (iii) the IA function can play a value adding role in modern organizations by expanding its scope of services to embrace operational areas. As Yee et al. (2008) explain, IA may allow a company to improve its efficiency so that during times of economic downturn it is their competitors who suffer the greatest share of loss of surplus-value and capital. According to Marx (1981), in equilibrium, profit-making companies all earn a general rate of profit on invested capital but in times of downturn firms try to force losses on to their competitors. They also recommend the need to explore the role and effectiveness of IA in the Middle-East, because in a developing country the IA function might be important in ensuring that capital is not wasted through inefficiency, fraud or corruption.

Cohen and Sayag's (2010) study explored the determinants of IA effectiveness by developing a model of its determinants. The model consists of six potential factors which may impact on IA effectiveness, namely, the sector of the organization; professional proficiency of internal auditors; quality of audit work; organizational independence; career and advancement; and top management support. They state that IA effectiveness is an important concept rarely examined in the academic literature. In the few studies dealing with IA effectiveness, mostly there was a concentration on the external auditor and whether the external auditor utilizes the work of the internal auditor. The results of Cohen and Sayag's (2010) study suggest that there are very high correlations between perceptions of top management support and IA effectiveness.

2.3. INTERNAL AUDIT AS A RISK MANAGEMENT MECHANISM

Value addition to the entity can be given by the internal auditors. It can be done by giving assurance that its exposures regarding risk are properly managed and understood (Leithhead, 1999). Internal audit need to play a vital role in monitoring the risk profile of a company. Moreover, it should identify areas in order to better the risk management procedures (Lindow and Race, 2002). An internal audit can be helpful for organizations in identifying and evaluating risks and putting the profession at the front line of the risk management (Walker et al., 2003). Further, Kwan (1999) describes that within a company, development of a risk based culture is required in order to build a strong organizational commitment for risk management. This should result in the development of an integrated risk management framework.

2.4. INTERNAL AUDIT AS A CONTROL MECHANISM

The management and directors of an entity adopt the process of internal control. This process gives assurance about the achievement of the entity's objectives regarding financial reporting, operations and compliance with the regulations (COSO Report, 1992). External auditing standards (Such as: AUS, 402 and ISA, 400) shows that the control environment can be strengthen by using effective internal audit function by: (i) Review of the internal control structure of a firm, (ii) On behalf of the management; monitoring different operations regarding the information system and control procedures. The asymmetry of information between divisional managers and senior managers result in weakling the ability of the senior managers to firmly control operations. The reason for this problem is the presence of internal agency costs (Ettredge et al., 2000) which occurs between the upper management and the lower level staff because of the incentive's differences. So the use of strong internal controls system including the internal audit for reviewing and monitoring mechanism. So keeping this in mind, senior management can delegate their responsibilities in accordance with the internal control to the internal audit function (Chambers, 1981).

2.5. INTERNAL AUDIT AS INTERNAL GOVERNANCE MECHANISM

From the agency point of view, the role of strong governance within a firm lays by aligning the management interests with the stakeholders in order to minimize agency costs (Cohen et al., 2002). An independent board chairman, independent directors on the board, internal audit, external audit and effective audit committee are different corporate governance mechanisms used to monitor behavior of the management (Cohen et al., 2004; Davidson et al., 2005). According to (Cohen et al., 2004) the complex interactions within these governance mechanisms are like a "corporate governance mosaic". But problems between independent and executive directors due to asymmetry information shows internal audit more likely as a complementary mechanism. This is supported by determining evidences from the researches examining the relationship between audit committees and internal audit (Carcello et al., 2005). This is in accordance with the IIA view about internal auditing; which helps organizations to improve and evaluate governance processes.

2.6. THE INDEPENDENCE OF INTERNAL AUDIT DEPARTMENTS

The concept of independence is generally used to mean the ability of the auditor to be fair and objective in his/her review and appraisal and not to be under undue pressure from any party to the extent that this could bias his/her opinion. The IIA's Standards for Professional Practice of Internal Auditing (glossary) defines independence of internal auditors as: 'The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels'(Institute of Internal Auditors 2011b). Independence of IA has been identified by the IIA, the American Institute of Certified Public Accountants (AICPA) and others as crucial to the viability of the IA function. The IIA has issued a number of attribute standards under which the IIA explored the issue of independence in the ISPPIA, more specifically, the Standard 1100 Independence and Objectivity. This standard states that the internal audit activity should be independent in performing their work. The Standard 1100 states: "that independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner" (Institute of Internal Auditors 2011).

A large body of research has examined auditor independence, but this has been predominantly in the context of external audit (Gendron & Bedard 2006). In other words, limited prior research has focused on internal auditor independence. In the few studies dealing with IA effectiveness, they have mostly concentrated on the external audit and whether the external auditors utilize the work of the internal auditors (Cohen & Sayag 2010). However, recently, there has been more attention to issues associated with the independence of IA (Stewart & Subramaniam 2010). This growth in research, as explained earlier, relates to the way the role of IA is gradually being transformed from primarily being concerned with checking the propriety of transactions and records and a systems evaluation approach, to becoming a value-adding service with a broader scope of activities, including assisting organizations in the management of risk.

Subsequently, the role of IA has developed to a pre-eminent position of advising the board of directors, although tensions remain between this consulting role and the need for independence (Mihret, James & Mula 2010). IA services derive their value and credibility from the fundamental assumptions of independence of mind and independence in appearance (Stewart & Subramaniam 2010). Vanasco, Skousen and Santagato (1996) point out that without independence the desired results of internal auditing cannot be realized. Therefore, the position of IA in an organization is bounded; it is a corporate unit that should have a large degree of autonomy and independence in order to perform its activities in a proper manner (Arena & Azzone 2009), and the independence of IA activity is a prerequisite to providing a wide range of IA services.

Similarly, Clark, Gibbs and Schroeder (1981) find that the independence of the internal audit department is the most important criteria influencing IA services. Bou-Raad (2000) believes that the strength of an internal audit department is assessed according to the level of IA independence from management and from other operating responsibilities. Independence of internal auditors increases the internal auditor‘s effectiveness because this independence may reduce the level of conflict between loyalty to the employer and loyalty to specific managers, and gives auditors an encouraging work environment in which they can perform their task without pressure. Thus, internal auditors should be sufficiently independent from the auditee to be able to conduct their work objectively and without interference (Cohen & Sayag 2010).

2.7. COMPETENCE OF INTERNAL AUDITORS

For IA to be effective, internal auditors need appropriate competence to perform their work satisfactorily (Burnaby et al. 2009). This view is supported by Al-Twaijry, Brierley and Gwilliam (2003) who suggest that the staffing of internal audit departments and the management of its staff is vital to the effective operation of IA, and that unless they possess the necessary competencies the power of internal auditors may be diminished. Mihret, James and Mula (2010) also support this view by stating that technical competence and continuous training are considered essential for effective internal audit'. Libby and Frederick (1990) indicate that experience is an important tool in enhancing auditors‘knowledge.

In addition, Bonner and Lewis (1990) state that years of experience is considered as an indicator of auditors‘knowledge and expertise. Internal auditors require a wide range of competencies to achieve satisfactory performance in the various hierarchical positions within internal audit departments (Burnaby et al. 2009). Competence requires knowledge and professionalism that the auditor should acquire from education, on-the-job training, and experience. Thus, legislators set requirements that must be met before people are qualified and entitled to perform audits (Paape 2007). Engle (1999) categorizes the most important benefits that will be realized from competent internal audit staff, namely, 1) staff will be able to conduct useful audits that effectively contribute to the achievement of organizational goals; 2) internal auditor‘s competence will increase the probability that external auditors use the work of internal auditors, leading to a potential reduction in the cost of external audits; and 3) internal auditors who are familiar with the organization under audit are in an ideal position to provide information about financial statements.

2.8. THE SCOPE OF INTERNAL AUDIT WORK

IA scope is another important factor that impacts on IA effectiveness. Al-Twaijry, Brierley and Gwilliam (2003) state that the scope of IA work is a significant indicator of IA effectiveness—a viewpoint which is supported by ISPPIA. In general, audit work should cover all systems and activities in all departments and locations throughout the organization. The International Federation of Accountants (2007) states that the scope of internal audit functions varies widely and depends on the size and structure of the entity and the requirements of management. Nevertheless, internal audit activities may include the following: 1. Monitoring and reviewing internal control systems, and recommending improvements thereto; 2. Examination of financial and operating information. The internal audit function includes reviewing the means used to identify, measure, classify and report financial and operating information, and specific inquiry into individual items including detailed testing of transactions, balances and procedures; 3. Review of the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity; 4. Review of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements (The International Federation of Accountants 2007). The scope of IA is also expanding to determine whether the systems designed by management are adequate and effective and whether the activities audited comply with the appropriate requirements (Fadzil, Haron & Jantan 2005).

The IIA‛s Standards for Professional Practice of Internal Auditing state that the IA activity must evaluate risk exposures relating to the organization‛s governance, operations, and information systems regarding the reliability and integrity of financial and operational information, effectiveness and efficiency of operations, safeguarding of assets, and reviewing the systems established to ensure compliance with those policies, plans, procedures, laws, regulations and contracts which could have a significant impact on operations and reports, and should determine whether the organization is in compliance (Institute of Internal Auditors 2011d). Internal audit also needs to carry out appraisal of existing systems and be involved in the revision or development of new systems before implementation. The internal audit function should assist management in the evaluation of new technology, especially in developing countries where the auditors ‛support in technical areas would arguably be more paramount than areas where the business practice remains relatively stable (Mihret & Woldeyohannis 2008).

2.9. INTERNAL AUDIT PERFORMANCE

The performance of the IA function should be monitored to ensure it provides value to the organization and carries out its role economically, efficiently and in accordance with best professional practice. In general, work performance involves internal auditors planning their audits, developing working programs, preparing time budgets for audit tasks, documenting all audit procedures in working papers and preparing internal audit reports. IA effectiveness is understood as the performance or efficiency of the tasks within the IA function (Santiso 2006). Performance is considered to be the most appropriate component in evaluating IA effectiveness (Rupšys & Boguslauskas 2007b) as it significantly influences the information and communication aspects of the internal control system (Fadzil, Haron & Jantan 2005). In line with various other researchers

(Santiso 2006), IA work performance is considered a major element of ISPPIA. The performance standards of the IIA require the auditor to plan and perform the work such that he or she would be able to arrive at useful audit findings and forward recommendations for improvement (Institute of Internal Auditors 2011). According to the definition of internal auditing (Institute of Internal Auditors 2011), IA is expected to add value to organizations by effectively managing IA activity; reviewing operations and programs to ascertain the extent to which results are consistent with the organization‘s goals; establishing audit plans, reports and programs to achieve audit objectives; and determining appropriate and sufficient timeframes to achieve objectives.

2.10. CO-OPERATION BETWEEN THE INTERNAL AND EXTERNAL AUDITOR

Internal audit departments should maintain good co-operation with external auditors for mutual benefit. Such a relationship between the internal and external auditors is very important for both parties because, in this way, external auditors have the opportunity to increase efficiency and credibility of financial statements; and it enables internal auditors to obtain essential information in the assessment of risks control. Mihret‘s (2010) study revealed the importance of internal and external audit linkages; and Arena and Azzone (2009) and Goodwin (2004) state that a positive interaction between IA and external audit is very important for both aspects. The relationship between the internal and the external auditors assists the board of directors through its audit committee to effectively oversee the audit process and the financial reporting process (Braiotta & Marsh 1992). The board of directors, the audit committees, executive managers, internal auditors and external auditors are the cornerstones of effective corporate governance in organizations. Therefore, effective corporate governance should be maintained based upon a strong relationship between external auditors and the internal audit function. The International Federation of Accountants (2007) highlights the need for coordinating the efforts of both internal and external auditors. The importance of the relationship between internal audit and external audit is reaffirmed by the International Federation of Accountants (2007, p. 7) as follows:

the role of the internal audit function is determined by management or those charged with governance. The objectives of management and those charged with governance differ from those of the external auditor whose overall objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor‘s findings. The objectives of the internal audit function vary according to the requirements of management or those charged with governance.

The internal audit function may achieve its objectives in a manner similar to that of the external auditor. Accordingly, certain aspects of the internal audit function‘s activities may be useful to the external auditor in determining the nature, timing and extent of audit procedures to be performed. Notwithstanding its degree of autonomy and objectivity, the internal audit function is not independent of management or the entity. The external auditor has sole responsibility for the audit opinion expressed and, accordingly, that responsibility is not reduced by the external auditor‘s use of the work of the internal audit function‘. Therefore, there is no doubt neither party can do without the other; and the work and success of one party is crucial to the success of the other. As a result, the interaction between the internal and external auditors should contribute to IA effectiveness.

3. CONCLUSION

The literature and the IIA definition of internal indicate that internal auditing has become an integral part of organizational structure as a value adding service to organisations. The validity of the notion of internal audits as value-adding and its contribution to organizational goal achievement rest on the implied assumption that internal audit is effective. Unquestionably, effective internal auditing is beneficial to organizations in accomplishing their goals and objectives. Nonetheless, to date, there has been scant research conducted on IA effectiveness. Prior IA research also has, for the most part, focussed on developed countries. Accordingly, internal audit appears generally, and IA effectiveness specifically, to be under-researched particularly in the context of developing countries. The increasing globalization of the world economy and the adoption of the International Monetary Fund (IMF) and World Bank-led economic reforms are factors now driving the surging interest in corporate governance practices in several developing countries Therefore, it is important to understand internal audit practices in these environments. Apart from contributing to the literature, studies on IA in developing countries could potentially provide a more holistic understanding of the nature, context and processes of internal audit.

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