



Critical Analysis of Internal Audit Independence: International Literature

Sourour Hazami – Ammar

Higher Institute of Business Studies (IHEC Sfax), Sfax, Tunisia,
Route Sidi Mansour Km 10, 3061 Sfax – Tunisie.

Abstract

This article provides an analysis of internal auditor independence framework by proposing and comparing the thesis of independence as a social construct and its antithesis as a myth. Extensive reviews of empirical research allow us to evaluate the key levers of audit committees, and the conditions of effectiveness of these bodies. Independence of the internal auditor is described as essential to sit his assessments. However, his position as an employee, with a subordination agreement with an employer, may affect his own judgment. Such a conflict threatens the independence of the internal auditor through its programming independence, investigation and / or reports. An "optimal" level of independence is built. It is clear that an independent audit committee, accessible and / or competent often contributes to the preservation of the independence of the internal auditor. The ambiguity of roles between assurance and consulting, not recognized as such by internal auditors may impair independence. The limitations and possible extensions of this line of research are discussed.

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Keywords: Internal Auditor Independence; Social Construct; Myth; Audit Committee; Senior Management.

Introduction

Internal audit is a field of research that attracts less francophone researchers. However, several issues are likely to result in the continuation of a study. This is precisely the case of the independence of Internal Audit. The objective of this paper is to provide a review of the evolving literature on internal auditor's independence in order to emphasize gaps in knowledge and make recommendations for future research. In this article, we try to assess the extent to which, internal auditor manages to reconcile his hierarchical dependence and his mind independence. We don't claim to be exhaustive. We are pursuing a selective approach. Our work is built on the assumption of an internal function to the organization. The basic idea was the number of IIA standards that deal with independence. Indeed, the auditing standards reflect a highly standardized approach (Pigé, 2011). In France, unlike Anglo-Saxon countries, it is still unusual for the internal audit function to be outsourced. Our interest in favor of the internal audit

aligns with the current trend of Anglo-Saxon studies investigating its many facets. This is understandable because, internationally, during the financial crisis and the series of bankruptcy, internal audit has not failed. At WorldCom, it is precisely the internal audit which revealed the fraud to light. Enron, its role has not been filled since Arthur Andersen was both the outsourced internal audit and the external auditor. In the minds of senior managers, internal auditors work for their accounts and report to the audit committee is a formality to meet the requirements of corporate governance (Drent, 2002). At the same time, internal audit must add value to management and not become its servant. Hence, the independence of internal audit is built in response to a given organizational context. After some work in the American context (Gramling *et al.*, 2004, Christopher *et al.*, 2009), the purpose of this article is to provide an international overview of research concerned with independence of internal audit. Our work extends that of Stewart and Subramaniam (2010). By focusing on the swallow problem, it develops a deeper analysis of the barriers related to audit independence. Thus, our investigation partially responds to the need expressed by these authors, to better consider the institutional context in which internal audit operates. This empirical component promotes confrontation of theories with the realities on the ground. Our synthesis of this body of literature is divided into two parts, which draw the two sections of the article. First, we discuss the context of independence construction. At this point, we appreciate the ability of the internal audit supported by the audit committee to build independence. Secondly, we will study relations between the audit independence and attributes of audit function. So, we question the barriers of audit independence and an acceptable level of audit independence.

Internal Audit Independence as a Social Construct

Independence: A Compromise Socially Constructed

Why is it so necessary to strengthen internal audit independence? Independence constitutes the heart of internal audit profession [39]. Independence is especially the main guarantee of objectivity of opinion. Without independence, internal audit cannot fulfill its role as an institutional mechanism in place to regulate the behavior of stakeholders [9] [5]. Internal audit, which is a management emanation, was not regarded as a governance mechanism within agency theory but recent developments in corporate governance [10] in corporate, it as a mechanism for regulating the relationship between manager and various stakeholders [18]. Being a clearing cost to the agent loading, internal auditor reports to principals (different stakeholders) that manager acts in accordance with the interests of the former. If independence, core business of internal audit, is a guarantee for shareholders (in theory, at least), what does this concept cover? Very typically, much of independence literature of auditors (external auditors specifically) distinguishes between the appearance of independence and independence is "often called independence of mind" [36]. Psychological independence or fact refers to the mental processes of auditor, as a professional practitioner, analyzing objectively and unbiased different audit evidence. Independence of mind is unobservable, approaches from the perceptions of shareholders, investors, financial market, etc. [4]. Internal audit must be independent and internal auditor must carry out their work with objectivity (standard 1100). We understand that independence refers to the state of audit environment. Objectivity, relating to the quality of assessments, is a state of mind in which prejudice not unduly affects the judgment and decisions. It refers to the organizational status of internal audit and organizational policies that affect internal audit independence. Independence is the foundation and may be the most important factor establishing the stature of Internal Auditing [22]. A model is developed built on the basis of three attributes of the strength of the internal audit function [13]: competence, performance and objectivity. The results show that the internal auditor's objectivity is the most dominant factor and leads the external auditors to receive a higher quality for the function. Mautz and Sharaf [29] support the idea that the professional must maintain a sincere disinterest, promote unbiased judgments and review determining facts of a definitive opinion. They suggest the recognition of the independence of programming, investigative independence, and independence of the reports. Because of the lack of independence of internal audit, some research suggests that the internal audit is inherently inferior to the external audit profession leading to a problematic reputation. In principle, internal audit should be independent and objective. However, in practice, it may not be completely independent. This is referred to a level of independence called "optimal". Moreover, research indicates that this level of independence is materialized by certain limits or boundaries that the internal auditor has to manage. And the involvement of management in the planning of internal audit could have a negative impact on the independence [11]. The meaning of what constitutes independence of internal audit would be socially constructed within the time and space, but also a compromise (with respect to an ideal situation).

Audit Committee: To Strengthen Internal Audit Independence

Audit committee greatly enhances internal audit independence [14]. In addition to its activities related to external audit functions, the audit committee exercises leadership of internal audit [15]. From a case study of a British financial company, Turley and Zaman [46] show that the chief internal auditor has seized the audit committee in order to avoid a reduction in its resources by management. Such a conception requires that the audit committee provides a minimum of independence and competence, if it exists within the organization. We only deal with the relationship between internal audit and audit committee members because they are the main actors of the internal

audit function [40] [18]. We aren't interested with literature review on relation between audit committee and internal audit. Rather we focus on some important findings made through research on the relationship between these two mechanisms of governance. The presence of the audit committee has a positive effect on users' perception regarding the independence of the internal audit and the reliability of financial reporting [19]. Krishnan [28] supports this view by considering that the status of the audit committee is enhanced because it can rely on the work of internal audit. This reinforcement is felt from the moment the audit committee acts as an independent body for internal audit to raise issues related to the management [16] [46]. Independence reporting improves the control environment and reduces the risk of errors. Goodwin [17] went further to indicate that independence is further improved if the audit committee members, in addition to being independent, have the technical expertise to understand the work of the internal audit. The importance of internal audit with independent status through appropriate management position was reinforced by IIA [21], which significantly emphasized that internal audit must be functionally dependent to the audit committee. However, many observers of corporate governance point to a symbiotic relationship between internal audit and audit committee. Yet, an effective audit committee helps raise internal audit status, in return; it can help avoid financial anomalies [30]. Although the studies conducted so far have not yet explored how an internal audit can do it, some recent studies suggest that improving the quality of internal control is likely to reduce the incidence of financial anomalies [28]. Merely the ability of the internal audit to address the concerns of the audit committee may be limited by budget constraints and competition with the direction in the management of scarce resources. According to Goodwin [17], audit committee's technical expertise to understand the work of the internal audit reinforces its independence. This follows an earlier study, by Raghunan *et al* [37] who found that an audit committee composed exclusively of independent directors, and at least one member with accounting and financial expertise, is more exposed to have long meetings with internal audit, to provide access and review programs and internal audit results. The financial expertise of the audit committee appears to be a determinant of reliability of internal control, and quality of relations between the chief of internal audit and management [35]. Independence is identified by an appropriate hierarchical position within the organization. Moreover, the internal audit function may not be related to the audit committee. In such a case, the non-involvement of the audit committee in the appointment decisions, evaluation and dismissal can only threaten the independence of the internal audit [11]. In summary, a perceived independent internal auditor improves the audit committee status. Also, the presence of audit committee has a positive effect on users' perception regarding the independence of internal audit. These mutual effects must, however, be nuanced particularly in light of the insights gained from studies and the inevitable influence of senior management. The impact of the quality of internal control seems pretty convincing by acting directly on financial anomalies and indirectly on the independence of the internal audit and the nature of the relationship linking it to a competent and independent audit committee.

Independence of Internal Audit Built in the Heart of Conflicts of Interest

Internal audit is in a position where he must constantly manage conflicts of interest that occur to him throughout the audit process. These conflicts of interest directly influence his independence. Conflicts of interest may result from the person or the personal environment of the teams or the general environment in which the activity takes place. Regarding conflicts of interest resulting from the person, internal audit independence is affirmed to fight against the internal audit practice overloaded with tasks that should not be placed upon them. The conflict of interest is deemed to endanger the ability of a person to exercise independently his activities. There are no differences for the internal audit. He must avoid any situation that might affect the confidence in him, and by extension that placed at his colleagues. The latter is often responsible for defining and drafting rules and work procedures and to assess their operation below. Besides, Sarens and De Beelde [39] show, based on a study of five Belgian companies, that internal audit is operating mainly in a supporting role to the management. Then its objectivity is perceived as affected and its relationship with audit committee as impaired. This explains why international standards of IIA require that the internal audit must be attached at the highest level, it must be independent from those responsible for the audited function. In this standard, the word "value" has been reproduced twice. What value are we talking about? Under the standard 2000 "The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization." Also, according to Standard 2010.C1, "The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Accepted engagements must be included in the plan" Firstly, reading these standards, it is likely that IIA refers to two categories of value: intangible value and financial value. Beyond the traditional financial approach to business performance, the value created extends to all stakeholders [12] [33]. The organization, seen through the prism of a repertoire of skills, behavior and mental agility, is developed by its various stakeholders, including internal audit. Concerning the financial value, this one once created should it be shared? If yes, internal audit independence is likely to be put to the test. It could be the case if internal auditor receives an incentive fee or even shares in the companies in which he is employed. Faced with such a conflict of interest, internal audit tends to overlook management actions that overstate earnings, compromising its objectivity. In principle, the extent of audit procedures must be directly related to the assessment by internal audit of the probability of risk [38]. "All things being equal, if the risks increase, substantive procedures

should be extended" (POB 2000). The research related to the extended verification procedures were examined in different contexts of risk assessment such as the risk of fraud, the risk of not going concern, the risk of earnings manipulation and risk related to corporate governance. Some of these studies found a positive relationship between risk assessment and audit effort. However, other studies did not find evidence for an association between the risk and extent of audit work. These contradictory findings suggest further research on the judgments of internal audit regarding the potential extension of audit procedures. But anyway, when objectivity is compromised by incentives, internal auditor tends to ignore the guidelines on the extent of audit procedures. Thus, an internal auditor, being in a conflict of interest in the source of incentives, should arbitrate to preserve his independence. So we can say that the independence of internal audit is built according to the intensity of the conflict of interest it faces during the audit process; it is also built based on its ability to manage these conflicts. Conflicts of interest that internal auditor faces are materialized during discussions occurred, in the one hand with management, and with audit committee in the other [11]. Audit committee, communicating with financial management and internal audit can affect the independence of the latter and thus contribute to its construction. Moreover, the fact that internal auditors are functionally dependent to the CFO or CEO, [3] [31], can be explained only by the search for an appropriate level of independence especially after the failure of the external audit. These consultations are for internal auditor salient moments of construction of his independence. The result is an independence socially constructed by actors having divergent interests.

Internal Audit independence is Still a Myth

Roles of Internal Audit: Complementarity or Ambiguity

Internal audit, providing assurance and consulting activities, adds value to overall company performance if the formers are complement. Consulting services, being in rapid development, distinguishes internal audit from any action of "policeman" but it is confusing. In principle, the objectivity of internal auditor is presumed to be impaired when undertaking a monitoring activity for which he was responsible during the previous year (1130 standard). A supposed transparency occurs because the purpose, authority and responsibility of the internal audit activity must be formally defined in a charter, consistent with the standards and duly approved by the audit committee (1000 standard). But this dualism provides our suspicion about the ability of the preservation of the internal audit independence. Indeed, a significant debate has the merit of being recently engaged by audit literature [45] because internal audit might be in a situation of conflict. The majority of prior studies pointing finger at this confusion, have focused on internal audit's perceptions about their roles. Allegrini et al. [1], in their review of European literature on internal auditing, report that consulting generally forms a relatively small part of internal audit activities in Europe. However, consulting activities appear to be increasing. For example, Allegrini and Bandettini [1] indicate an increase from 7 to 26 per cent of time allocated to consulting activities in Italian companies. Sarens and Beelde [39] also report that, in the six companies that comprised their case study, consulting activities ranged from a low of 15% to a high of 69% of internal audit activities. Paape, and Snoep Scheffe [31] found that 64% of respondents to their survey, among chief internal auditors across fifteen European countries said their function engaged in consultancy and management support activities. In addition, 61% of respondents disagreed with the suggestion that it is better for the internal audit not to accept consulting assignments in order to protect and maintain independence.

Van Peurse [47], interviewing a survey of New Zealand internal auditors, identifies that internal auditor perceive some functions as essential to fulfill their roles. The survey also sought to understand the nature of the internal auditor's "role dilemma" which comes from the expectation that internal auditors will both assist management and independently assess the management of the organization.

Comments received from respondents indicated that the role of internal audit has changed in recent years to be a consultant rather than a "policeman". Most of those who commented on this change don't perceive it as a problem. Van Peurse [48] followed her study with multiple case studies involving six senior internal auditors. The study was designed to explain how these internal auditors can resolve the conflict between their responsibilities to oversee and audit and the provision of management support. Van Peurse finds that the tension involved in the maintenance of this dual role leads to role confusion and that this lack of precision is not necessarily undesirable. The few studies presented here, far from the sake of generalization, present results that differ. Attempts to distinguish between assurance and consulting activities entrusted to the internal auditor and limiting the second to a fully inserted into the audit charter list may not be the only solution to guarantee the independence of internal audit. In addition, internal audit are engaged in a large deal of consulting activities. It seems that they support this initiative as one that adds value to the organization. However, there are problems of role conflict that can create problems of objectivity. It is possible that the commitment in both assurance and consulting services results in a self-examination and / or a threat of social pressure risk. Also, if the involvement in the consulting results in a participation in incentive systems, there is, in this case, a threat of economic interest. Clearly, there are gaps in the literature which offer prospects for future research. We know that internal audit usually engage in consulting activities. In addition, they feel that the opportunity to add value to the organization is open to them. The literature does not inform us about the

frequency and nature of incentive remuneration for internal audit. The most common types of plans involved bonuses based on overall company performance, internal audit function performance and individual performance.

The impact of these different types of schemes on objectivity of the internal auditor is clearly an important way to conduct research. What about authority? To objectively fulfill both roles, does internal auditor need the power and influence? Literature regarding internal audit's authority shows that management is more likely to comply with the recommendations of the internal audit if the authority presses the action. At this level, the posture adopted by internal auditor dictate his behavior. That is to say, some internal auditors are more consultative on operations and control issues while others maintain their independence and objectivity in order to strengthen their oversight roles. According to Jackson and Schuler [21], unclear roles have a negative relationship on independence, length of employment and job performance.

Internal Audit Attaching: Functional or Hierarchical

Internal audit's function can adopt several possible structures. On assignment to the Chief Accountant, during the 60s and 70s, internal audit takes place in a narrow scope to the financial field. Then we are seeing to the years 2004-2005, a scenario hoped by internal auditor who is actually attached to senior management.

In France, 70% of internal audit services benefit of this positioning. And more recently, the internal audit is attached to senior management and / or audit committee. This structure, widely practiced in the Anglo-Saxon groups, is supposed to guarantee the independence of the function. This attachment is not avoidable in that managers carry the responsibility of internal control's quality [35]. It is logical that the internal audit of a small business is not organized in the same way as that of a multinational. In addition, the internal audit activities vary from one organization to another depending on the size of organization, type of operations, capital structure, legal and regulatory environment, etc. The research examining characteristics of this function and their impact on the internal audit independence does not exist to our knowledge. Internal audit's perceptions regarding their contributions to the external audit have been redesigned to be influenced by the independence and competence of audit committee; the latter's commitment regarding internal audit's function as well as the size of this function. Audit committee undertakes recently an important governance role in the coordination and supervision of communication between management, internal audit and external auditor. Gramling *et al* [18] point out that a quality relationship between the internal audit function (IAF) and the audit committee is also working to provide the IAF an appropriate environment and support system to carry out its activities related to governance (risk assessment, control assurance, respect for the work).

Internal audit is supposed to provide an objective and independent judgment on the process of risk management, control and corporate governance of organization. It is also employed by it. This opens the door to possible significant tensions. Thus, its independence from management is required to evaluate the actions of the latter objectively. Most previous studies focus on the relationship of internal audit with audit committee. Most of these studies are based on surveys and interviews with auditors. An exception is Carcello *et al* [8] which examines the audit charters and audit committee's reports of 150 American companies. The authors noted that information relating to the external audit are much more frequent than those relating to internal audit. Within results, only 50% of the sample firms include an audit committee that holds private meetings with internal audit. Stewart, in a study conducted with Australian internal auditors, found that the existence of an effective audit committee has had little impact on the perception of internal auditors and their willingness to act objectively.

An absent or malfunctioning Audit Committee towards internal audit inhibits the independence of the latter. Diagnosing about the impact of organizational position on the independence of internal audit; returns to investigate the nature of the relationship between internal audit and management. Nevertheless, research on the impact of this relationship on the objectivity of internal audit is very limited.

A study of the perceptions and expectations of management and internal audit regarding the relationship between the two parties provides an appropriate depth. Internal audit is influenced by senior management and the latter participates in its acceptance and appreciation. James [24] examined the perceptions of US loan responsible towards the ability of internal audit to prevent financial statement's fraud.

The study revealed that internal audit functions attached to senior management are seen as less able to prevent fraudulent claims from those that are positioned to the audit committee.

Previous research provides some indication of the impact of organizational status on the objectivity of the internal audit. The impact of audit committee, through its relationship with internal audit, attracted the attention of researchers. However, we do not know if audit committee plays a key role in the independence of the internal audit. Also very little is known about the attitudes of the management with regard to the objectivity of the internal audit, and whether their ability to act impartially is reinforced when they report to the audit committee. In addition, relationship between functional independence of internal audit (a situation which allows an objective attitude) and

objectivity (state of mind of internal auditor) is relatively unexplored. If it is accepted that CFO declaration is likely to compromise independence and objectivity of internal audit, there is little research that has examined the impact of direct relationship with management through principal manager. Also, the studies cited here, the only found, relate to specific contexts and cultures (USA and Belgium).

Rethinking Independence through Management of Threats

An acceptable level of independence is the subject of consultation. Far from being an acquisition, the internal auditor continuously manages the various threats through a self-assessment process [20]. We propose in the following a brief overview of this framework and we then discuss with the support of qualitative studies that corroborate restricting the independence of internal audit. Individually, seven threats influence the internal auditor's objectivity. These are (i) self-assessment, when an auditor reviews his own work, (ii) social pressure, where this latter is exposed to the pressure exerted on him by the audited company or even team members, (iii) the economic interest resulting for example from a bonus or verification of work by one who has the power to influence employment of the internal auditor or his salary, (iv) personal relationship, if internal auditor is a close relative or friend of the manager ; (v) knowledge, resulting from long-term relationship with the auditee, including having worked in the audited entity (vi) cultural, racial and gender biases that arise in multinational organizations where the internal audit is biased by a lack of understanding of the local culture and customs, and (vii) the cognitive bias resulting from preconceived notions or adoption of an individual psychological perspective when performing the audit.

Linked to the company by a subordination relationship, internal auditor tends to start his work with the desire to achieve a positive conclusion on the regularity and sincerity of his employer. This link opens the door to several conflicts of interest; the fight is in principle a matter of conscience and deliberate choice. Burnaby *et al* [7] reported that 67% of respondents to the survey CBOK believed that they conform to the standard 1100. While 88% agreed that the standard provides adequate guidelines regarding independence and objectivity.

However Paape [32] argues that the two concepts are not well defined and are relative in nature, since internal auditors are employees of the entity. Christopher *et al* [11], by interviewing 34 Chief Audit Executive (CAE); highlight obstacles to internal audit's independence. Firstly, we can mention the involvement of the CEO or CFO to the prior approval of the audit budget or even the audit plan.

Among the threats, the authors also postpone the lack of reporting to the audit committee and absence of commitment to the decisions of the appointment and dismissal of the CAE and the lack of expertise of audit committee. The results of this study are partly due to the obligations of the management regarding regulatory reporting on internal control weaknesses. Internal audit is not disconnected from the mechanism of disclosure under SOX (2002) and the French Law on Financial Security (2003). The relationship of subordination should not leave us perplexed when internal auditors are predisposed to take the position that is in the best interests of their employers [6]. Schneider [43] examined the impact on the objectivity of the internal audit of a threat of economic interest in the form of incentive payments and stock ownership. He suggested that the participation of internal auditor in these reward systems is a direct result of their participation in the consulting business, enabling them to participate in creating value and overall business performance.

Schneider used an experimental model to examine whether such compensation may influence the willingness of American internal auditors to report a violation of GAAP by recognizing a lack of inventory. However, it is difficult to understand why an incentive payment related to the share price has impacted while the related earning does not. In addition, there was no evidence that a lack of stocks can influence the willingness of internal audit to report a violation to GAAP. Indeed, internal auditors require that management supports them and to get that support, they must meet their needs [39] [6]. This can then affect their independence or objectivity. So the external auditor may not give attention to the judgment objectivity of internal auditor [41]. Yet the internal audit function is likely to recognize the existence of fraud perpetuated by the management of the company that employs them.

Conclusion

This review of the empirical research provides an initial assessment of the independence of internal audit. In a climate of suspicion about the effectiveness of the external audit and an environment of increased regulation since the early 2000s, leading to a strengthening of internal audit function, this contribution is analyzed by presenting the thesis: independence is a social construct, and anti - thesis: independence is a myth. The independence of internal auditors is not a due, it must be earned; but it is favored in part by their reporting line to the senior management and secondly by their functional reporting line to the Audit Committee. The thesis is facing to an anti - thesis.

The independence of internal audit is built according to a given context. That is, the existence or not of an audit committee, its independence and competence. It is also the nature of the relationship between audit committee and internal audit and the hierarchical position of the function. In addition, the internal audit, to be independent, must be

able to handle multiple conflicts of interest.

The links between the independence of internal audit and context parameters have been empirically validated by the studies cited in this census. The independence of internal audit is a myth in the sense that the internal auditor is in a dependent position towards management. The prevailing conception, according to the studies reviewed is that internal audit helps improve control activities.

Consulting roles, which overlap relative to that assurance, aren't thought to be a limiting factor for independence. Rather, they meet to internal audit's expectations. Furthermore, independence is a myth because of the lack of research on the possible link between the structure of the audit function and independence. A possible link, if empirically validated, can only improve the process of its preservation. The independence, far from being given, raises from internal auditor a permanent threat management as part of a self-assessment process. Psychological perspective suggests that this process is unconscious and unintentional.

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Authors' Information

PhD in management, Poitiers Institute of Business Administration (France), Associate Professor, Sfax Higher Institute of Business Studies (Tunisia), in charge of several courses (financial accounting, internal controls, corporate governance, management accounting, management control, accounting theory, etc.) and author of several articles.

Authors' Biography(Optional)

Sourour Hazami – Ammar, PhD in management, IAE (Poitier – France), Associate Professor, IHEC (Sfax – Tunisia), she is founder and responsible of a professional master at IHEC. She is also author of several courses and articles.