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Internal audit independence and objectivity: a review of current literature and opportunities for future research

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**INTERNAL AUDIT INDEPENDENCE AND OBJECTIVITY: A
REVIEW OF CURRENT LITERATURE AND OPPORTUNITIES
FOR FUTURE RESEARCH**

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ABSTRACT:

This paper reviews the recent European and international literature on internal audit independence and objectivity. We focus on studies involving internal auditors that have been undertaken since the Institute of Internal Auditors' revised definition of internal audit in 1999. The topics we examine are the internal auditor's dual role as a provider of both assurance and consulting activities, the organizational status of internal audit, internal audit's involvement in risk management, outsourcing and co-sourcing of internal audit activities and the use of internal audit as a training ground for managers. Following our review of each of these topics, we discuss opportunities for further research.

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INTERNAL AUDIT INDEPENDENCE AND OBJECTIVITY: A REVIEW OF CURRENT LITERATURE AND OPPORTUNITIES FOR FUTURE RESEARCH

Introduction

Auditor independence and objectivity are the cornerstones of the profession. The assurance services provided by auditors derive their value and credibility from the fundamental assumptions of independence of mind and independence in appearance. Prior research on auditor independence and objectivity has been undertaken predominantly in the context of external audit. However, in more recent years, there has been heightened interest in issues associated with the independence and objectivity of internal audit. The motivation for research growth in the area is related to the evolving and expanding role of internal audit as a key corporate governance mechanism as well as an internal consultancy service. In this regard, internal auditors are in a unique situation as providers of both assurance services within the organization and consultancy services to managers. Not surprisingly, this dual role has generated significant debate as it has the potential to place the internal auditor in a situation of conflict. Furthermore, as employees of the organization, the ability of internal auditors to exercise true objectivity has also been questioned (Paape, 2007).

In recognition of the potential for conflict, the Institute of Internal Auditors (IIA) has issued a number of professional standards and guidelines with respect to independence and objectivity. In fact, in 2001 the IIA published "*Independence and Objectivity: A Framework for Internal Auditors*" (IIA, 2001) as a guide for managing threats to objectivity. The framework identifies seven key threats: self-review, social pressure, economic interest, personal relationship, familiarity, cultural and cognitive biases. It also identifies a variety of safeguards against these threats.

The objective of this paper is to provide a review of the evolving literature on internal audit objectivity in order to highlight gaps in knowledge and make recommendations for future research. As a basis for our review, we draw on the current definition of internal audit promulgated by the IIA, together with the guidelines and standards on independence and objectivity. Our focus is on the literature in this area since the new definition of internal auditing was released in 1999.

Prior literature reviews of internal audit

To date, there have only been a limited number of prior reviews of the internal audit literature. Bailey, Gramling and Ramamoorti (2003) edited a monograph published by the IIA Research Foundation on research opportunities in internal auditing. There were two key objectives of this monograph. It was intended, first, to inspire academic research on topics of relevance to internal auditing and, second, to bridge the gap between academics and practitioners. As such, it is a blend of theory and practice, designed to familiarize academic researchers with internal audit practice (Editorial Preface, xi – xii). Each chapter of the monograph raises a series of research questions related to a specific topic in internal auditing and we refer to these where relevant.

Gramling, Maletta, Schneider and Church (2004) examined the literature and future research opportunities relating to the role of the internal audit function in corporate governance. These authors focused on the relationship between internal audit and the other cornerstones of governance (i.e. external auditors, the audit committee and management). They also evaluated the literature on internal audit quality (including objectivity and independence). However, much of the research cited relates to external auditors' evaluations of internal audit quality and on external auditors' reliance on the work of internal audit. The authors provide an excellent synthesis of the literature in this area, largely from a North American perspective. Hence, in this paper, we concentrate on research relating directly to internal auditors and the internal audit function, particularly focusing on studies from other parts of the world.

In 2006, the IIA commissioned the 2006 Global Common Body of Knowledge study, engaging researchers from around the world “to better understand the expanding scope of internal audit practice” (Cooper, Leung and Wong, 2006). An initial phase of this study has resulted in three related literature reviews. Cooper et al. (2006) examined the internal auditing literature in the Asia Pacific region, Hass, Abdolmohammadi and Burnaby (2006) studied the literature from the Americas, while Allegrini, D’Onza, Paape, Melville and Sarens (2006) performed a similar review of the European literature. The purpose of these reviews was to document changes in internal audit as a result of shifts in global business practices. Where relevant, we draw on aspects of these studies that relate to internal audit objectivity.

Background - professional guidance relating to independence and objectivity

In this section we review the professional guidance pertaining to internal audit independence and objectivity. We commence with the definition of internal audit put forward by the IIA (1999). We then summarize the IIA Code of Ethics (2000) with respect to objectivity. We follow this with an overview of the professional standards and other guidance that the IIA has issued on independence and objectivity.

The IIA (1999) definition of internal auditing is now familiar and well accepted:

“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.”

This definition highlights the independence and objectivity of internal auditing with respect to both assurance services and consulting. Independence and objectivity are closely related and are sometimes used within the IIA Standards in a somewhat circular manner. Indeed, the IIA (2001) acknowledges that the terms have been used interchangeably and with a lack of clarity. However, the Glossary to the IIA Standards distinguishes between the two concepts in the following way:

“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.”

“Objectivity – An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others.”

Hence, the IIA distinction between the two terms appears to be that objectivity is a state of mind while independence is the state of affairs that permits an internal auditor

to operate with an objective attitude. While the IIA standards emphasize independence at the organizational level, the definition indicates that it is also important at the individual, engagement and function levels.

The IIA Code of Ethics consists of a number of basic principles which internal auditors are expected to uphold, together with rules of conduct which describe the norms of behaviour expected of internal auditors. The principle relating to objectivity requires internal auditors to “exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined.” Furthermore, internal auditors are expected to make a balanced assessment of all the relevant circumstances and they should not be unduly influenced by their own or others’ interests when forming judgments. The rules of conduct specify that internal auditors:

- (i) shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment;
- (ii) shall not accept anything that may impair or be presumed to impair their professional judgment;
- (iii) shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

The IIA has issued a number of attribute standards and associated advisory statements relating to independence and objectivity. Standard 1100 states that “the internal audit activity should be independent, and internal auditors should be objective in performing their work.” The related Practice Advisory 1100-1 indicates that independence allows internal auditors to be impartial and unbiased in the exercise of judgment and is achieved through organizational status and objectivity.

Attribute standard 1110 discusses organizational independence based on the chief audit executive (CAE) reporting to a level in the organization that permits the internal audit activity to fulfill its responsibilities. The various practice advisory statements relating to this standard stress that the CAE should ideally report functionally to the audit committee (or the board) and administratively to the chief executive officer (CEO). As a minimum, administrative reporting should be to an executive with

sufficient authority to promote independence and provide the internal audit function with the appropriate stature and status in the organization.

Attribute standard 1120 relates to individual objectivity and requires internal auditors to “have an impartial, unbiased attitude and avoid conflicts of interest.” The related Practice Advisory statement stresses the need to avoid potential and actual conflicts of interest and bias at the individual level. The statement suggests that staff assignments should be rotated periodically and highlights the importance of not accepting fees, gifts or entertainment from their audit clients. Attribute Standard 1130 discusses the need to adequately disclose to appropriate parties any impairment to independence or objectivity. Examples of impairment discussed in implementation standards include internal auditors assessing operations for which they were previously responsible. Other impairments noted (in the Glossary to the Standards) are personal conflicts of interest, scope and resource limitations, and restrictions on access to records, personnel and property. Practice Advisory 1130.A1-1 does not permit staff transferred or temporarily assigned to internal audit to undertake audits of activities that they previously performed until at least one year has elapsed.

In addition to the standards and advisory statements, we noted earlier that the IIA has also published a framework to guide internal auditors with respect to objectivity (IIA, 2001). This framework requires internal auditors to identify, assess and manage threats to their objectivity, including the need to consider safeguards that can mitigate the effects of the threats. An excellent summary of this framework is provided by Mutchler (2003)¹ in her discussion of research opportunities related to this framework. To avoid duplication, we only provide an overview of the framework while, in subsequent sections of the paper, we extend and discuss Mutchler’s suggestions for research in the area.

On an individual level, the framework discusses seven threats to an internal auditor’s objectivity. These are (i) self-review, where the internal auditor reviews his/her own work; (ii) social pressure, where the internal auditor is exposed to pressure from, say, the auditee, or others on the audit team; (iii) economic interest, resulting, for example, from incentive payments or from auditing the work of someone who has the power to affect the internal auditor’s employment or salary; (iv) personal relationship, where

¹ This work comprises Chapter 7 of Bailey et al. (2003).

the internal auditor is a relative or friend of the auditee; (v) familiarity, resulting from a long term relationship with the auditee including having worked in the unit being audited; (vi) cultural, racial and gender biases arising in multinational organizations when the auditor is biased or lacks an understanding of local culture and customs; and (vii) cognitive biases resulting from preconceived notions or the adoption of a particular psychological perspective when performing the audit. These threats can also occur at the internal audit department level, particularly when the function is involved in both consulting and assurance activities.

The framework also gives examples of mitigating factors that act as safeguards against the threats to objectivity. Examples include organizational position and policy statements which increase the status of internal auditors in the organization, a strong and supportive governance environment, appropriate incentive schemes which reward objectivity, the use of teams, and adequate supervision of staff.

In summary, it is apparent that the IIA is taking a strong stance on the need for independence and objectivity. However, as Paape (2007) stresses, the two concepts are not well defined and are relative in nature, given that internal auditors are employees of the entity.

The extant literature and research opportunities

To avoid replication of previous literature reviews, we do not cover the whole spectrum of internal audit research. Rather, we focus on specific areas of significance to internal audit objectivity where we perceive a need for further research. As noted, our emphasis is on work that has engaged internal auditors rather than on work that examines the perceptions of external auditors.² We also restrict our discussion of prior studies to those that have been conducted since the revised definition of internal audit in 1999.

The topics that we discuss are: (i) assurance versus consulting; (ii) organizational status; (iii) internal audit's role in risk management; (iv) outsourcing and co-sourcing internal audit activities; and (v) internal audit as a management training ground. For

²As previously noted, for a detailed review of external auditors' evaluation of and reliance on the work of internal audit, particularly from a North American perspective, see Gramling et al. (2004).

each topic, we summarize the key studies, highlight the gaps in knowledge and discuss opportunities for future research.

Assurance versus consulting

The IIA definition of internal audit highlights the value-adding role of internal audit as an assurance and consulting activity.³ A number of studies around the world have examined the extent to which internal audit engages in consulting activities.

A study by Nagy and Cenker (2002) examined whether the new definition actually reflected the activities of internal auditors. The researchers interviewed eleven US directors of internal audit, addressing issues and highlighting changes associated with audit scope, organizational structure, risk management and audit committee expectations. The study found that the change in definition simply reflected existing practice, with internal auditors having performed consulting services and other value-added activities for many years.

Several European studies provide evidence of the extent of internal audit engagement in consulting activities. For example, Arena, Arnaboldi and Azzone (2006) undertook a multiple case study of internal audit functions in six Italian companies and found that only one of the functions engaged significantly in consulting activities. Allegrini et al. (2006), in their literature review of European internal auditing, report that consulting generally forms a relatively small part of internal audit activities in Europe (e.g. in France, assurance services represent 73% of work (Institut Francais de l'Audit et du Contrôle Interne, 2005), in Belgium, consulting averages 12 per cent of annual working time (IIA Belgium, 2006), while in Italy, only a few large companies (8% of the top 100 firms) use internal audit for consulting activities (Allegrini and D'Onza, 2003)). However, consulting activities appear to be increasing – for example, Allegrini and Bandettini (2006) indicate an increase from 7 to 26 per cent of time allocated to consulting activities in Italian companies. Sarens and de Beelde (2006) 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, Scheffe and Snoep (2003) found that 64% of respondents to their survey of

³ Anderson (2003) provides a general discussion of research opportunities relating to assurance and consulting services in Chapter 4 of Bailey et al. (2003). Internal audit objectivity is only a small part of this discussion.

chief internal auditors across fifteen European nations reported that their function engaged in consultancy and management support activities. Furthermore, 61% of respondents disagreed with the suggestion that it is better for internal audit not to accept consultancy assignments in order to protect and maintain independence.

Selim, Sudarsanam and Lavine (2003) examined the role of internal audit in mergers, acquisitions and divestitures (M, A & D). The research involved interviewing internal auditors and senior managers in 22 companies in the US and Europe. They found that internal audit played a relatively small role in M, A & D activities but that interviewees believed that opportunities exist for a more pro-active role, notably in the areas of advising management and providing consulting services.

Van Peurse (2004) conducted a survey of New Zealand internal auditors to identify functions that internal auditors perceive to be essential to their role. The survey also sought to understand the nature of the internal auditor's "role dilemma" (p. 379) which arises from the expectation that internal auditors will both assist management and independently evaluate management. Comments received from respondents indicated that internal audit's role has changed in recent years to one of consultant rather than of "policeman". Most of those who commented on this change did not perceive it as a problem. Van Peurse (2005) followed up her survey with a multiple case study involving six senior internal auditors. The study was designed to explain how these internal auditors deal with the conflict between their audit oversight responsibilities and the provision of support to management. Van Peurse found that the tension involved in maintaining this dual role leads to role ambiguity but that this ambiguity is not necessarily undesirable. Three concepts emerged from the interviews which impact on internal auditors' ability to maintain their independence: the position in which they establish their own role and duties; the role of professional status; and the nature of the communications in which they engage.

Schneider (2003) considered the impact on internal audit objectivity of an economic interest threat in the form of incentive payments and stock ownership. He suggests that internal audit participation in these reward schemes is a direct result of their involvement in business consultancy, enabling them to add value to overall company performance. Schneider used an experimental design to examine whether the type of compensation would influence US internal auditors' willingness to report the failure

to recognize an inventory loss (a GAAP violation). He found that, when compensation was tied to stock price, a significantly higher percentage of internal auditors would not report the GAAP violation compared to when the compensation was tied to earnings or was fixed. However, it is unclear why an incentive payment linked to stock price had an impact while one linked to earnings did not. Further, there was no evidence that stock ownership influenced internal auditors' willingness to report the GAAP violation.

Two other experimental studies conducted in the US have addressed the concern that the dual role of assurance provider and consultant can create bias and hence cause problems for internal audit objectivity. Both Brody and Lowe (2000) and Ahlawat and Lowe (2004) examined whether internal auditors can remain objective when consulting to management in a corporate acquisition setting. The two studies involved internal auditors acting for the buyer or seller in an acquisition. The role that the company was taking in the negotiation process was found to influence participants' judgments, with internal auditors allocated to the buyer condition providing significantly higher likelihood judgments about inventory obsolescence compared to those allocated to the seller condition. The researchers conclude that this suggests that internal auditors who act as consultants may not be able to maintain their objectivity.

Table 1: Assurance versus Consulting (*see end*)

The above synthesis (summarized in Table 1) indicates that internal auditors are engaging in a greater amount of consulting activities. It appears that they support this move as one which adds value to the organization. However, there are role conflict issues which can create objectivity problems. It is possible that engaging in both assurance and consulting activities gives rise to a self-review threat and/or a social pressure threat.

There are clearly gaps in the literature which indicate opportunities for further research. We know that internal auditors are engaging in more consulting activities and that they perceive that this is an opportunity to add value to their organization. From the small number of experimental studies that have been conducted, it appears that internal auditors do not act without bias when performing consulting activities.

However, these studies need to be replicated and extended to different situations and different groups of internal auditors to determine the generalizability of the findings. We also need to identify and test factors that might mitigate any potential biases. In addition, we do not know how the performance of consulting activities impacts assurance services and whether internal auditors are able to maintain their objectivity when they provide both types of services to a client. Van Peurse's (2005) work makes a valuable contribution to our understanding of how internal auditors balance their assurance and consulting roles. However, her evidence is drawn from interviews with six New Zealand internal auditors, only one of whom was employed in a major corporation. Four participants came from public sector or quasi-public sector organizations while the fifth participant was an internal audit outsource provider. Hence, further research is needed in other contexts and jurisdictions to elaborate and extend this work.

Organizational status

Internal auditors are in a unique position in terms of their status as employees of an organization with responsibility to act as internal assurance providers. This requires internal auditors to assess and monitor various governance decisions made by management and also to advise management on the adequacy and effectiveness of internal controls (Sarens and de Beelde, 2006). It is thus no surprise that internal auditors can face considerable familiarity and social pressure threats stemming from their relationship with management. In more recent years, audit committees have undertaken an important governance role in coordinating and overseeing the communications between management, internal auditors, and external auditors. Gramling et al. (2004) highlight that "a quality relationship between the IAF (internal audit function) and the audit committee also works towards providing the IAF with an appropriate environment and support system for carrying out its own governance related activities (e.g. risk assessment, control assurance and compliance work)" (p.198). In addition, corporate governance guidelines and listing rules explicitly recognize the governance role played by audit committees in enhancing the relationships between management, external auditors and internal auditors (Blue Ribbon Committee, 1999; Smith Committee, 2003). As such, audit committees can be viewed as a key safeguard mechanism for internal auditors in managing their professional objectivity.

A small number of prior studies have examined the relationship between internal audit and the audit committee. Most of these involve surveys or interviews of internal auditors. An exception is Carcello, Hermanson and Neal (2002) who examined audit committee charters and reports of 150 US companies. Part of their study looks at disclosures relating to auditor oversight. They found that disclosures relating to external audit were much more prevalent than those relating to internal audit, with less than 50% of companies in their sample reporting that the audit committee held private meetings with internal audit.

Surveys of internal auditors have generally indicated that the composition of the audit committee is associated with the strength of the relationship between the internal audit function and the audit committee. Raghunandan, Read and Rama (2001), in a survey of US chief internal auditors⁴, assessed the joint effect of audit committee independence and expertise on the committee's interaction with internal audit. They found that independent committees with at least one member with accounting or finance expertise had longer meetings and more private meetings with the chief internal auditor. Goodwin and Yeo (2001) surveyed chief internal auditors in Singapore and found that audit committees comprised solely of independent directors had more frequent meetings and more private meetings with the chief internal auditor. Goodwin (2003) obtained similar results in a survey of chief internal auditors from Australia and New Zealand. In contrast, however, O'Leary and Stewart (2007), in a study of Australian internal auditors' ethical decision making, found that the existence of an effective audit committee had little impact on internal auditors' perceptions of their willingness to act objectively.

The involvement of the audit committee in decisions to dismiss the chief internal auditor is another indicator of internal audit independence. Prior studies have obtained mixed results in this regard. For example, Goodwin and Yeo (2001) report that 72% of audit committees in their Singapore study were involved in dismissal decisions while Goodwin (2003) found only 52% of Australian and New Zealand audit committees were similarly involved. Only Goodwin (2003) found a relationship between dismissal decisions and the independence of the audit committee.

⁴ This study extended an earlier Canadian study by Scarbrough, Rama and Raghunandan (1998).

Studies based on in-depth interviews of internal auditors and audit committee members suggest that audit committees may strengthen internal auditors' status and in turn their ability to remain objective and independent. Turley and Zaman (2004) conducted interviews with a variety of personnel from a large UK financial services company (of which one interviewee was the head of group internal audit and another, the audit committee chair). Based on these interviews, the authors argue that an audit committee is able to set a 'tone' that allows internal audit to have a certain degree of influence in the organization. As such, an effective audit committee is seen to play a critical role in supporting the internal auditor's position.

In a similar vein, Mat Zain and Subramaniam's (2007) study of heads of internal audit from eleven organizations in Malaysia reflects the importance of the powerful position of audit committees in enhancing internal audit objectivity. The study reveals that internal auditors place significant trust in audit committees to take up the key questioning role in more formal settings. This finding raises the possibility of a cultural effect stemming from the fact that Malaysia is a high power distance nation (Hofstede, 1981), where the cultural norm emphasizes class distinctions based on the level of authority.

James (2003) examined the perceptions of bank lending officers with respect to the impact of reporting structure on internal audit's ability to prevent financial statement fraud. The study found that internal audit functions that report to senior management are perceived as being less able to prevent fraudulent reporting compared to those departments that report solely to the audit committee.

Recent research examining the relationship between internal audit and senior management and its impact on internal audit objectivity is very limited. Van Peurse's (2005) study, discussed in the previous section, is relevant to this issue as she found that internal auditors' close relationship with management can place their independence from management at risk. The study by Sarens and de Beelde (2006) also contributes to our understanding of this issue. These authors used a case study approach of five Belgian companies to explore the expectations and perceptions of both senior management and internal auditors with respect to the relationship between the two parties. They found that, when internal audit operates primarily in a

management support role, there is a lack of perceived objectivity and the relationship with the audit committee is weak.

Table 2 provides a summary of the above studies.

Table 2: Organizational Status (*see end*)

While prior research has provided some insights into the impact of organizational status on internal audit objectivity, there are a number of avenues for further research. Very little is known about management's attitudes towards internal audit objectivity and how reporting to the audit committee affects objectivity. Further, the relationship between internal audit independence (the state of affairs that permits an objective attitude) and objectivity (the state of mind) is relatively unexplored. In addition, while it is recognized that reporting to the chief financial officer is likely to compromise internal audit independence and objectivity, there has been little research that has examined the impact of reporting to more senior management such as the CEO.

We also do not know whether the results of prior studies are generalizable to other jurisdictions and cultures. Of note, cultural dimensions such as power distance could be driving the results of studies in Eastern cultures such as Malaysia and Singapore and this warrants further exploration. Finally, alternative research designs could add insight to our understanding of the relation between organizational status and internal audit objectivity. For example, experimental designs could be undertaken in order to identify causal relationships more easily.

Internal audit's role in risk management

Recent corporate governance developments have raised the profile of risk management within organizations. While the prime responsibility for risk management lies with the directors and senior management, internal auditors are also seen as key contributors as consultants and assurance providers on risk management processes and systems. In particular, the internal auditing profession has become a key driver of the concept of enterprise risk management (ERM), defined by COSO (2004) as the

“process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives...”

In 2004, the IIA, in conjunction with COSO, issued a position statement on the role of internal audit in ERM, suggesting ways for internal auditors to maintain their objectivity and independence (IIA, 2004). This position paper outlines the recommended roles of internal audit in ERM, roles that are legitimate with safeguards, and roles that should not be undertaken. These roles are listed in Table 3 (*see end*) Both COSO and the IIA emphasize that management has the ultimate responsibility for ERM.

In 2005, the IIA conducted a global online survey of internal auditors regarding their involvement in ERM (Gramling and Myers, 2006). Responses were received from 361 IIA members. The survey found that internal audit was primarily responsible for ERM in 36 percent of the respondents’ organizations. Further, the study also found that some internal auditors were engaged in roles that the IIA has determined internal auditors should not undertake.

Ernst and Young’s (2006) third Australasian benchmarking survey indicates that 62% of respondents’ internal audit functions are involved in providing assurance over risk management practices, while 47% report that internal audit develops and assists in the oversight of the risk management framework.⁵ The report also raised concerns over whether it is best practice for internal audit to be involved in both developing and assuring risk management frameworks and processes.

Fraser and Henry (2007) undertook a series of interviews of the finance director, the audit committee chair, and, where applicable, the head of internal audit and the director of risk management in five large UK organizations, as well as an audit

⁵ This survey involved respondents from ASX Top 200, NZX Top 100, and a cross section of federal, state and local government entities.

partner of from each of the Big Four audit firms. They found that internal audit tends to play a major role in ERM, particularly in the embedding of risk. More interestingly, they also found evidence of internal auditors having responsibility for ERM practices, despite the COSO and IIA position paper stating that responsibility must rest with management. For example, in one organization the internal auditor had been responsible for setting up the system, while in another there were concerns that an internal audit function that was composed predominantly of accountants and at the same time heavily involved in risk management may not identify certain risks.

The recent study by de Zwaan, Subramaniam and Stewart (2007) examined whether the extent of (1) internal auditors' involvement in ERM and (2) their interactions with the audit committee affected the perceptions of internal auditors' professional objectivity. Data analysis was based on an experimental questionnaire survey of 117 certified internal auditors in Australia. The results indicate that internal auditors' involvement in ERM is likely to have a significant and negative effect on their objectivity in terms of their willingness to report on breakdown of risk procedures to the audit committee. However, the level of internal auditors' interactions with their audit committees (i.e. *high vs. low*) was found to have only a marginal effect. There was also no significant interaction found between the two independent variables affecting respondents' perceptions of internal auditor objectivity.

The role of internal audit in ERM and its implications for internal auditors' objectivity is an emerging area on which there is limited empirical evidence. Table 4 (*see end*) summarizes the academic research in this area. With the exception of de Zwaan et al. (2007), the existing research in the area is generally descriptive. There are numerous opportunities for future research on the implications of internal auditors' involvement in ERM on their professional objectivity. In particular, further study is needed on how different types of safeguards may mitigate threats to objectivity. Examples of safeguards include the roles played by audit committees, by separate risk management committees and by the external auditors. Further research is needed to identify how these safeguards are able to assist internal audit to play an optimum role in the establishment of ERM frameworks while being in a position to monitor and provide assurance on the frameworks once they are operating. There is also scope for more in-depth examination of differences in the role played by internal auditors in ERM

and its implications for their objectivity across different sectors, industries and business structures. Of note, ERM is becoming widely used in public sector entities and early evidence suggests that internal auditors are playing an important role in this development (de Zwaan et al., 2007). Further research focused on the public sector is needed to fully understand this role.

Outsourcing and co-sourcing internal audit activities

Outsourcing and co-sourcing of internal audit services have become widespread in recent years (Ernst & Young 2006; Caplan and Kirschenheiter 2000). While it is no longer acceptable for external auditors to provide internal audit services to their audit clients (Sarbanes-Oxley, 2002), such services are provided by both public accounting and specialist firms to non-audit clients (Ernst & Young 2006). A recent study of Australian publicly listed firms by Carey, Subramaniam and Ching (2006) suggests that 45% of the 99 respondent firms that utilized an internal audit function had outsourced some or all of their internal audit activities. Further, the type of services outsourced included both traditional financial statement audit-related services such as review of internal controls and testing of account balances, and also compliance and performance audit services including risk management and regulatory compliance evaluations.

It has been argued that an outsourced provider may be more objective than an in-house internal audit function as it is difficult for an employee to be truly independent of management (James, 2003). Research in this area is limited to a few studies. James examined lending officers' perceptions of the impact of outsourcing on internal audit quality and found that 85% of participants perceived an in-house internal audit function to be less objective than a Big-5 accounting firm and the remaining 11% perceived them to be equally objective. Selim and Yiannakas (2000) explored the extent of internal audit outsourcing in the United Kingdom. Respondents from the forty organizations that did engage in either outsourcing or co-sourcing were asked whether the judgment of an outside contractor is more likely to be impartial. The mean response to this question was 2.3, below the mid-point on their scale of one to five. Ahlawat and Lowe (2004) explored this issue in an experimental study where both in-house and outside internal audit providers assumed the role of internal auditor for the buyer or the seller in an acquisition target. They found that advocacy existed in

both groups but that it was more extreme amongst the in-house internal auditors compared to the outside providers. Finally, Gramling and Vandervelde (2006) conducted an experimental study with both internal and external auditors. They found that, while the external auditor respondents assessed internal audit objectivity as higher when the provider was another accounting firm, the internal auditor respondents assessed objectivity to be higher when internal audit was provided in-house.

There are a number of opportunities for further research relating to outsourcing and co-sourcing. More studies are needed that examine differences in both perceptions of objectivity and actual objectivity between in-house internal audit functions and outside providers. We do not know whether differences in objectivity are affected by the nature of the activity being undertaken by internal audit. Ahlawat and Lowe (2004), for example, tested a consultancy situation and found that outside providers appeared to be more objective than in-house internal auditors. However, no prior studies have examined objectivity differences in the context of assurance services.

There are also factors that could affect the objectivity of outsourced providers in the same way that external auditor independence can be compromised. For example, the fear of losing a major client, involvement in both consulting and assurance work, and social and other relationships with the client may all lead to a compromise of objectivity. However, none of these issues have been explored empirically. Prior research has also not addressed the issue of co-sourcing, where outside providers are brought in at peak times or to perform specific tasks. Are these providers more or less objective than in-house internal auditors?

A further issue identified by Subramaniam, Ng and Carey (2004), based on their survey of 41 Australian public sector entities, is that audit committee involvement in the decision to outsource internal audit activities appears to be stronger in entities that adopt full outsourcing of the internal audit function. However, in situations of co-sourcing, the head of the in-house internal audit function and other management appear to play a more active role. Interestingly, when contractual problems arise with external providers, the audit committee's involvement in the follow-up and evaluation processes appears to be minimal. Hence, further enquiry into the role of audit

committees as a safeguard measure in situations when there is risk of loss of internal audit objectivity appears warranted.

A related issue that warrants further investigation is whether reporting relationships that strengthen internal audit can be maintained when the activities are outsourced. For example, internal audit's interactions with the audit committee can strengthen the function's objectivity when internal audit is provided in-house. However, we have little understanding of the relationships that exist between audit committees and outsourced internal audit providers and whether the same level of interaction can exist between the two parties. Hence, whether or not an outside internal audit provider has or needs the same protection from the audit committee as an in-house function and whether this impacts on internal audit objectivity remain avenues for future research.

Internal audit as a management training ground

The use of internal audit as a training ground for future management personnel is commonplace. There are two approaches to this practice. First, new graduates can be hired as internal auditors, with the intent of transferring them to line management positions after a few years in internal audit. Second, existing employees can be seconded to the internal audit function for a period of time. At the end of the period, they are transferred back to line functions, often in a higher operational position (Goodwin and Yeo, 2001).

This practice has many advantages for the organization but it can pose a threat to internal audit independence and objectivity. Internal auditors may be reluctant to take strong positions on issues that arise if they know they are likely to be transferred back to the department they are currently auditing. The problem is enhanced when the person in charge of the department may become the internal auditor's immediate superior once he or she is transferred back to the line position. The IIA has partially recognized this threat by not permitting staff transferred to internal audit to audit activities they previously performed until at least one year has elapsed. However, there is no guidance on the situation where staff may be transferred to the activity they are currently auditing.

Some studies have provided ad hoc evidence of the prevalence of using internal audit as a training ground in European organizations. Arena et al. (2006) found that internal

audit was seen as a training function in two of the six companies in their case study. Sarens and de Beelde (2006) report that, in one of their cases, the CFO expected internal audit to be a training ground for future potential managers. The internal audit manager described the function as a fishing pond full of high potential, suggesting that, as a result, the function lacked people with both audit experience and company experience. Selim et al. (2003) report that some companies in their study of both US and European acquisitions and mergers established rotation programs whereby new employees were offered a rotation through internal audit as part of their training program.

Goodwin and Yeo (2001) is the only study that has investigated the impact on objectivity of using internal audit as a training ground. They surveyed 65 chief internal auditors in Singapore to explore the extent of the practice and perceptions of whether it could impair objectivity. The study found that internal auditing was viewed as a stepping stone to a managerial position in 43% of companies, that internal auditors would in the future be transferred to line positions in 48% of companies and that an auditee could be the future boss of an internal auditor in 49% of companies. Some 32% of respondents believed that using the internal audit function as a management training ground could impair the work of internal auditors.

This is clearly an area where more research is needed. We do not know exactly how prevalent the practice is on a global basis and we do not know whether the practice does in fact impair internal audit objectivity. There would appear to be social pressure and economic interest threats to objectivity under both of the approaches to using internal audit as a management training ground. Further, the second approach of transferring existing employees to work in internal audit can give rise to familiarity and self-review threats. These threats could be compounded by a lack of commitment to the internal audit profession, including an awareness and understanding of the IIA code of ethics. None of these issues have been explored in depth. Undoubtedly, there are benefits for the organization from using internal audit as a training ground but no study has weighed up the costs and benefits of the practice from the perspective of internal audit.

Conclusion

This paper has reviewed the recent literature on internal audit objectivity and independence in the current professional environment. We have focused our review on issues associated with the internal auditor's dual role as a provider of both assurance services and consulting activities, the organizational status of internal audit, internal audit's involvement in risk management, outsourcing of internal audit activities and the use of internal audit as a training ground for managers. In each case, we have discussed recent studies that have added to the body of knowledge relating to internal audit objectivity and highlighted opportunities for future research. From our review, it is clearly evident that internal audit objectivity is a rich and fruitful area of investigation where researchers can make a valuable contribution to the on-going development of the profession.

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Table 1: Assurance versus Consulting

Authors	Method	Sample	Description of study	Results
Nagy and Cenker (2002)	Interviews	11 internal audit directors of large US publicly traded companies	Interviews gained an assessment of internal audit in the following four areas of audit scope, organizational structure, risk management and AC. The assessment was in terms of changes in the internal audit department over a ten-year time frame.	Found a definite shift in the role of internal audit towards more operational activities; the new internal audit definition reflected current practice.
Arena, Arnaboldi and Azzone (2006)	Multiple Case Study	Six Italian companies	Comparison of internal audit practices in participating companies through multiple sources of information including semi-structured interviews with chief internal auditors, accounting and finance staff.	The range of situations considered highlighted the diversity of internal audit department characteristics, confirming the relevance of institutional pressures, but also providing evidence of the influence of additional elements in their development.
Sarens and De Beelde (2006)	Multiple Case Study / qualitative assessment	Five Belgian companies	Aims to understand the expectations and perceptions of internal audit and senior management with respect to each other through semi-structured interviews and supporting documentation.	Senior management's expectations have a significant influence on internal audit. Internal audit is able to meet those expectations, which makes senior management support them. In most cases internal audit is able to meet the expectations of the AC.
Paape, Scheffe and Snoep (2003)	Survey	105 Chief Audit Executives from European companies	Examines the relationship between the internal audit function and corporate governance among the top listed companies in the European Union.	Not all top listed EU companies have an IAF or an AC. Less than half of the respondents report to the AC. ACs generally meet four times a year. ACs are not always involved in the appointment and dismissal of the CAE. A significant percentage of respondents (28%) believe they aren't required to adhere to the Standards for the Professional Practice of Internal Auditing. Not all CAE's were aware of CG recommendations/ regulations.

Selim, Sudarsanam and Lavine (2003)	Survey / Interviews	22 companies from Europe and the USA	Determines the role of internal audit in mergers, acquisitions and divestitures. Used gap analysis to compare the normative, observed and preferred models of internal audit involvement in M, A & D.	Internal audit's involvement in M, A & D is only moderate. However, internal auditors see themselves capable of playing a larger role, a view supported by the senior executives in other functions.
Van Peurseem (2004)	Survey	161 New Zealand Internal Auditors	Determines if internal auditors perceive the functions they perform as essential and to what extent. Also explores whether internal audit exhibits the characteristics of a true profession with authority over, and independence from management.	Characteristics of 'true' profession exist but do not dominate. Public practice and experienced auditors may enjoy greater influence over management, and accountancy trained auditors may enjoy greater status.
Van Peurseem (2005)	Multiple Case Study	6 New Zealand Organizations	Examines the New Zealand internal auditor role and conceptualises on the auditor's influence over that role. Also addresses how an effective internal auditor can overcome the tension of working with management to improve performance while also remaining sufficiently distant from management in order to report on their performance.	Found three concepts of those that best balanced their role: the internal auditor's external professional status, the presence of a formal and informal communication network, and the internal auditor's place in determining their own role.
Schneider (2003)	Experimental Questionnaire	172 US Internal Auditors	Exploratory study that attempts to determine whether incentive compensation and stock ownership affect internal auditors' objectivity. This is assessed through the internal auditors' decision on whether to report a GAAP violation.	Stock ownership did not affect the internal auditors' reporting decision. When incentive compensation was tied to stock prices a significantly higher percentage of internal auditors would not report the GAAP violation than when the compensation was tied to earnings or when it was fixed salary.

Brody and Lowe (2000)	Experimental Questionnaire	55 US Internal Auditors	Explores whether internal auditors view their consulting role as one in which they are able to provide objective feedback to management or one in which they are to provide solutions that they believe are in the best interests of their company. Examines whether internal auditors' judgements are dependent on their company's role (buyer or seller) in an acquisition.	Internal auditors are likely to assume the position that is in the best interests of their employer. Provides evidence of the consulting role of internal auditors impairing their objectivity.
Ahlawat and Lowe (2004)	Experimental Questionnaire	66 US Internal Auditors	Examines whether the consulting role of internal auditors impacts on their ability to remain objective.	Significant advocacy existed in the judgement of both in-house and outsourced internal auditors.

Table 2: Organizational Status

Authors	Method	Sample	Description of study	Results
Carcello, Hermanson and Neal (2002)	Archival	150 US Companies	Explores AC activities and identifies possible areas for further AC reform. Included disclosures relating to auditor oversight.	Found disclosures relating to external audit were more prevalent than those relating to internal audit. Less than 50% of companies reported having private meetings with internal audit.
Raghunandan, Read and Rama (2001)	Survey	114 US Internal Auditors	Examines the association between AC composition and the committee's interaction with internal audit.	Found that ACs without 'gray' directors and at least one member with financial expertise will have longer meetings with the CAE provide private access to the CAE, and review the IA program, results and interaction with management. Provides empirical support that AC composition can impact on oversight activities.
Goodwin and Yeo (2001)	Survey	65 Singaporean Internal Auditors	Examines whether the relationship between internal audit and the AC influences the independence and objectivity of internal auditors.	found the level of interaction between an AC and internal audit was greater when the AC was comprised of independent directors.
Goodwin (2003)	Survey	120 Internal auditors from Australia and New Zealand	Explores the separate impact of AC independence and the proportion of members with accounting or finance experience on the AC's relations with the internal audit function. It also seeks to isolate differences between public and private sector ACs and between Australia and New Zealand.	Found independence and accounting experience have a complementary impact on AC relations with internal audit. AC independence was found to be more associated with issues of process while accounting experience is associated with AC reviewing the work of internal audit.

O'Leary and Stewart (2007)	Survey	66 Australian Internal Auditors	Exploratory study that assesses the impact of corporate governance mechanisms on the ethical decision-making of internal auditors. Also explores whether ethical decision-making is influenced by years of experience in internal auditing.	Found a higher quality external audit function was positively associated with internal auditors' ethical decision making. Other governance mechanisms did not appear to influence ethical decision making. Also, more experienced internal auditors adopted a more ethical stance in some cases.
Turley and Zaman (2007)	Case Study	1 UK Company	Investigates the conditions and processes affecting the operation and potential effectiveness of ACs, with particular focus on the interaction between the AC, individuals from financial reporting and internal audit functions and the external auditors.	Found that the AC was often most effective through informal processes. ACs have a significant influence on power relations between organizational participants. The perceived personal attributes of the AC and organizational culture seem to affect the ACs influence on governance outcomes.
Mat Zain and Subramaniam (2007)	Interviews	CAEs from 11 publicly listed companies in Malaysia	Seeks to provide insights into internal auditors' perceptions of their interactions with AC members in Malaysia.	Results indicate infrequent informal communications and limited private meetings between the CAE and AC, and a need for clear reporting lines. ACs are seen to be held in high esteem for their authority and are expected to take on greater leadership in the inquiry of management's decision-making.
James (2003)	Survey	63 US Bank Loan Officers	Examines whether internal audit reporting structure affects financial statement users' perceptions of ability of the internal audit function to prevent financial statement fraud.	Found in-house internal audit departments that report to senior management are perceived as less able to provide protection against fraudulent reporting compared to those that report solely to the audit committee.

Van Peurseem (2005)	Multiple Case Study	6 New Zealand Organizations	Examines the New Zealand internal auditor role and addresses how an effective internal auditor can overcome the tension of working with management to improve performance while also remaining sufficiently distant from management in order to report on their performance.	Found internal auditors' close relationship with management can place their independence from management at risk.
Sarens and De Beelde (2006)	Multiple Case Study / qualitative assessment	Five Belgian companies	Aims to understand the expectations and perceptions of internal audit and senior management with respect to each other through semi-structured interviews and supporting documentation.	Found that, when internal audit operates primarily in a management support role, there is a lack of perceived objectivity and the relationship with the audit committee is weak.

Table 3: Roles of Internal Audit in Enterprise Risk Management

Core Internal Audit Roles in ERM
<ul style="list-style-type: none"> • Giving assurance on risk management processes
<ul style="list-style-type: none"> • Giving assurance that risks are correctly evaluated
<ul style="list-style-type: none"> • Evaluating risk management processes
<ul style="list-style-type: none"> • Evaluating the reporting of risks
<ul style="list-style-type: none"> • Reviewing the management of key risks
Legitimate Internal Auditing Roles with Safeguards
<ul style="list-style-type: none"> • Facilitating identification and evaluation of risks
<ul style="list-style-type: none"> • Coaching management in responding to risks
<ul style="list-style-type: none"> • Coordinating ERM activities
<ul style="list-style-type: none"> • Consolidating the reporting on risks
<ul style="list-style-type: none"> • Maintaining and developing the ERM framework
<ul style="list-style-type: none"> • Championing establishment of ERM
<ul style="list-style-type: none"> • Developing risk management strategy for board approval
Roles Internal Auditing Should Not Undertake
<ul style="list-style-type: none"> • Setting the risk appetite
<ul style="list-style-type: none"> • Imposing risk management processes
<ul style="list-style-type: none"> • Management assurance on risks
<ul style="list-style-type: none"> • Taking decisions on risk responses
<ul style="list-style-type: none"> • Implementing risk responses on management’s behalf
<ul style="list-style-type: none"> • Accountability for risk management

Source: IIA (2004)

Table 4: Internal Audit's Role in Risk Management

Authors	Method	Sample	Description of study	Results
Gramling and Myers (2006)	Survey	361 global Internal Auditors	Examines the extent to which internal audit functions adhere to the ERM roles recommended by the IIA.	Survey found internal audit's role in core ERM roles could be extended as it is less than the department would prefer. Also found that IA's involvement in inappropriate activities is greater than it should be.
Fraser and Henry (2007)	Interviews	5 UK listed companies and 'big four' audit firms	Examines mechanisms for the identification and management of critical risks and also identifies what the role of internal audit and the audit committee should be in risk management.	Found that internal audit did have a role to play in risk management. However, due to expertise and independence issues it is recommended a separate risk function should be set up. Also found AC are increasingly involved in risk management but also recommends a risk committee be set up with the time and expertise to direct risk management.
de Zwaan, Subramaniam and Stewart (2007)	Survey	117 Australian Certified Internal Auditors	Examines whether internal auditor involvement in ERM, and the relationship with the AC have an impact on perceived objectivity.	Found that internal auditor involvement in ERM negatively impacts perceived objectivity. The relationship between internal audit and the AC has only a marginal effect on perceived objectivity.

Table 5: Outsourcing and Co-sourcing Internal Audit Activities

Authors	Method	Sample	Description of study	Results
Caplan and Kirschenheiter (2000)	Analytical Model		Uses agency theory to examine incentives for outsourcing the internal audit function to public accounting firms.	Found public accountants provide higher levels of testing, but possibly for a higher expected fee. This supports internal audit as the lower cost provider but the public accountant as a higher quality provider.
Carey, Subramaniam and Ching (2006)	Survey	304 Australian Listed Companies	Investigates the determinants of internal audit outsourcing.	Results suggest that internal audit outsourcing is associated with perceived cost savings and the technical competence of the external provider. Larger firms and smaller firms that are adopting internal audit for the first time are more likely to outsource.
James (2003)	Survey	63 US Bank Loan Officers	Examines whether internal audit sourcing arrangement affect financial statement users' perceptions of ability of the internal audit function to prevent financial statement fraud.	No difference found in users' perceptions of financial statement fraud prevention between outsourced and in-house internal audit departments that report to the audit committee. An outsourced internal audit team is perceived as having greater competence and objectivity but their limited presence in the company limits their ability to protect against fraud.
Selim and Yiannakas (2000)	Survey	165 UK Finance and/or Audit Directors	Examines the practice of outsourcing the internal audit function in the UK public and private sectors. Also examines how internal audit is perceived and the likely impact an outsourcing decision may have on auditors' independence and the quality of internal audit service.	Found that most organizations prefer an in-house internal audit function. The most important factor in seeking to outsource is access to specialized skills. Not all respondents believed independence to be compromised when internal audit is outsourced to the external auditor.

Ahlawat and Lowe (2004)	Experimental Questionnaire	66 US Internal Auditors	Examines whether the consulting role of internal auditors impacts on their ability to remain objective and whether an outsourced internal audit function is susceptible to client advocacy.	Found the extent of client advocacy was less severe in the case of outsourced internal auditors, as opposed to in-house auditors.
Gramling and Vandervelde (2006)	Experimental Questionnaire	21 Internal Auditors and 23 External Auditors from US	Tests the influence of the source of the internal audit function, whether in-house or external, on both the internal and external auditors' evaluation of the quality of the internal audit function.	Found assessments of competence, work quality and overall quality were not influenced by the internal audit sourcing arrangement but that objectivity was. Specifically, they found external auditors rate the objectivity of an outsourced function higher than in-house while internal auditors rate the objectivity of an in-house function higher.
Subramaniam, Ng and Carey (2004)	Survey	52 Australian Public sector entities	Examines the practice of outsourcing the internal audit function in Australian (Queensland) government entities.	Study found the practice of co-sourcing and outsourcing is common. The determinants of outsourcing primarily relate to non-financial reasons rather than financial. When the internal audit function is outsourced, audit committees play a key role in the outsourcing process.

Table 6: Internal Audit as a Management Training Ground

Authors	Method	Sample	Description of study	Results
Goodwin and Yeo (2001)	Survey	65 Singaporean Internal Auditors	Examines whether the use of internal audit as a management training ground influences the independence and objectivity of internal auditors.	Found that the internal auditor function is used quite extensively as a management training ground. Some 32% of respondents believed that the practice could impair internal audit objectivity.
Arena, Arnaboldi and Azzone (2006)	Multiple Case Study	Six Italian companies	Comparison of internal audit practices in participating companies through multiple sources of information including semi-structured interviews with chief internal auditors, accounting and finance staff.	Found that internal audit was seen as a training function in two of the six companies in their case study.
Sarens and De Beelde (2006)	Multiple Case Study / qualitative assessment	Five Belgian companies	Explores the expectations and perceptions of internal audit and senior management with respect to each other through semi-structured interviews and supporting documentation.	Found in one case that the CFO expected internal audit to be a training ground for future potential managers, describing the function as a “fishing pond” of talented staff.
Selim, Sudarsanam and Lavine (2003)	Survey / Interviews	22 companies from Europe and the USA	Determines the role of internal audit in mergers, acquisitions and divestitures. Uses gap analysis to compare the normative, observed and preferred models of internal audit involvement in mergers and acquisitions.	Found some companies established rotation programs whereby new employees were offered a rotation through internal audit as part of their training program.