Accountability structures and management relationships of internal audit

An Australian study

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Abstract

Purpose – The purpose of this study is to examine the accountability structures and the management relationships of internal audit. In particular, related issues such as the predominant internal audit objectives and the related functions, the extent to which internal audit addresses any financial reporting risks and the manner in which internal auditors in Australia perform their tasks, are identified. The study also looks at the extent of compliance with the Institute of Internal Auditors (IIA) Standards.

Design/methodology/approach – Based on a survey of the chief audit executives in Australia, the study identifies the reporting mechanisms, functions and relationships of internal audit, including the contributions made towards good corporate governance. There is, however, some misalignment between the aspirations of internal auditors and their relationships with management.

Findings – While internal audit objectives have been established with a focus on controls, risks and governance, the study has highlighted the fact that there is a lack of correlation between the tasks performed by internal auditors and the important internal audit objectives, with the exception of internal control and risks. The results also suggest that internal auditors have been providing an internal consulting and advisory role in matters concerning IT systems, strategic risks and financial issues. If internal auditors are to proactively contribute to good corporate governance, they need to define how, and in what way, this can be done. In regard to corporate governance processes, the results of the research indicate that issues surrounding internal control, risk assessment and management processes are regarded as the key factors for internal audit to contribute to good corporate governance.

Originality/value – This study complements and contributes to the existing literature in providing insights into the evolving role of the internal audit function in terms of accountabilities and relationships with management. It also provides a valuable insight into how the internal audit profession can build upon its inherent strengths and address any apparent areas of concern. This will assist both the profession and policy makers alike, in better understanding and improving the role of the internal audit process.

Keyword(s):

Internal auditing; Accountability structures; Management relationships; Corporate governance.

Introduction

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations (Institute of Internal Auditors (IIA), International Professional Practice Framework, 2009). The primary role of internal audit has been changing. Prior to 2000, one may have predicted that internal auditors would move away from basic compliance work to a future that would be dominated by consulting assignments. Then, with the series of large corporate collapses and the introduction of the Sarbanes-Oxley (SOX) Act (2002) in the USA and later the CLERP 9 Act (2004) in Australia, many internal audit functions refocused on financial controls auditing. When the IIA published its Common Body of Knowledge (CBOK) project results, some “big trends” stood out. The report noted that the focus of internal audit work, and how it is done, is likely to change and the role of internal auditing is forecast to become more strategic (Baker, 2007). In PwC's (2007) Internal Audit 2012 report, the finding of a study of *Fortune* 250 companies shows that two distinct models of internal audit value are emerging. The first is a continuation of what most internal audit functions in fact do now: providing assurance around the adequacy of the internal control system with the work clearly focused on controls. However, other internal auditors might go down a different path, as prompted by the SOX Act. Looking for new ways to add value, these internal auditors will concentrate on assurance around risk management processes.

The internal audit activity (IAA) must evaluate and contribute to the improvement of governance, risk management and control processes (Performance Standard 2100 Nature of Work: IIA, 2009). In respect of governance, the objectives of the IAA includes promoting appropriate ethics and values, ensuring effective organizational performance management and accountability, communicating risk and control information to appropriate areas of management and coordinating the activities of, and communicating information among, the board, external and internal auditors and management (Standard 2110 – Governance: IIA, 2009). Further, Standard 2060 (IIA, 2009) refers to the need for the Chief Audit Executive (CAE) to report periodically to senior management and the board on the IAA's purpose, authority, responsibility and performance relative to its plan. Reporting should also include significant risk exposures and control issues, including fraud risks, governance issues and other matters.

While the CBOK provides a broad overview of what internal auditors do, a closer consideration of the accountability structures and management relationships, the internal audit's objectives regarding compliance and risks, the impact of CLERP 9 relating to financial reporting risks, and the way how internal auditors work, is believed to be vital in gauging the changing landscape of internal auditing. This study aims to address this issue in the Australian context and in particular contribute to the literature on the accountability of internal auditors, their relationships with management and their objectives in the era post the implementation of SOX (2002) and the CLERP 9 Act (2004).

Literature review and research questions

Anecdotal and empirical evidence demonstrates that the internal auditing has been of interest to researchers with literature dating back to the early 1980s through to 2010 (Cooper and Craig, 1983; Stewart and Subramanium, 2010). The first known empirical study on the role of internal audit in Australia was undertaken by Cooper and Craig (1983). This seminal research on internal audit in Australia found a number of issues that were of concern to the profession, including a number of misconceptions about what internal auditors were doing and what their chief executive officers (CEOs) perceived was being done. Also, there were expectations by the CEOs that internal audit could do more than the traditional financial auditing work mainly being undertaken at the time. There was nevertheless strong support for internal audit by CEOs, but the profession in Australia in the early 1980s suffered from an image problem; it did not have a strong professional body to represent its interests as it has now; and there were no generally accepted professional qualifications recognised as necessary to practise as an internal auditor.

A later study in Australia by Cooper *et al.* (1994) aimed to provide a profile of internal audit in Australia in the 1990s and address a number of issues including attitudes and recognition; professionalism; role and scope of internal audit work; career opportunities; education and training and the future role of internal audit. In terms of attitudes and recognition, the overall view was a positive one, although there was some confusion between perceptions by CEOs and the reality as seen by the CAEs. The perceived high profile of internal audit as reported by the CEOs was not necessarily borne out by CEOs' understanding of the audit process, such as, for example, their strong support for the “mechanical” aspects of the process rather than a more management-oriented role for internal audit. Also, reporting levels were generally less than ideal and the confusion between perceived status and the reality of the situation was further reinforced by CAEs' views on how their role was seen by auditees, particularly in respect of a perceived policing function. This seminal study was undertaken before the development of modern internal auditing as we now know it. It did, however, set the scene for a number of subsequent studies in Australia, Hong Kong, Malaysia and New Zealand (Cooper *et al.*, 2006).

In a more recent study, Van Peursem (2004) also notes that Cooper *et al.* (1996) had identified a potential issue in confusion between expectations that internal auditors will both independently evaluate management's effectiveness and also aid management. Observations by Glascock (2002) and McCall (2002) have expressed similar concerns. Van Peursem (2004) also concludes that a key issue is that internal auditors will assume whatever position is in the best interests of their employer and will be reluctant to counter management, irrespective of the consequences, which is potentially damaging in terms of the image of the internal audit profession. Other similar studies such as James (2003), Zain and Subramaniam (2007) and Sarens and de Beelde (2006) also investigated the relationship between internal audit, expectations, perceptions and management.

In terms of accountability and management relationships, there are some conflicting findings. Gendron and Bedard (2006) reported that audit committee members were usually not confronted with difficult situations when discussing issues with the CAEs. However, Zain and Subramaniam (2007) observed that CAEs in Malaysia placed significant trust in audit committees in questioning issues at formal meetings. Sarens *et al.* (2009) also reported how internal audit is a “comfort provider” to the audit committee, especially in its assurance role and its involvement in improving internal controls. Norman *et al.* (2010) examined the effects of internal audit reporting lines on fraud risk assessments made by internal auditors and found that internal auditors perceive personal threats when they report high levels of risk directly to the audit committee, relative to management. Such perceived threats lead internal auditors to reduce assessed levels of fraud risk when reporting to the audit committee. This finding is in contrast to the anticipated benefits of the SOX requirements that the internal audit should report directly to the audit committee. Based on the above literature, the first research question is:

RQ1. What are the accountability structures and the management relationships of internal audit?

Goodwin-Stewart and Kent (2006) explored the voluntary use of internal audit by Australian publicly listed companies and sought to identify factors that lead listed companies to have an IAA. The results indicate that while size appears to be the dominant influence in establishing an IAA, there is also a strong association between internal audit and the level of commitment to risk management. However, the study found only weak support for an association between the use of internal audit and strong corporate governance. The study indicates that a number of Australian listed companies do not use internal audit and many that do, have only one or two internal audit staff, a finding supported by this study. Goodwin-Stewart and Kent (2006) also note that the implications of these findings for contributing to sound corporate governance are serious, as it has been suggested that it is difficult for audit committees to be effective without the support of internal audit. It would appear that there is considerable scope for strengthening the relationship between internal audit, audit committees and external auditors.

Hass *et al.* (2006) observe an outcome of the current regulatory climate in the USA (and to a lesser extent, Australia) is that many internal audit resources are now spent on SOX compliance assurance work. A survey of audit managers undertaken in 2005 indicated that SOX (2002) first year compliance efforts utilized 50 percent or more of internal audit work (PwC, 2006). This emphasis means that limited internal audit resources are being diverted from operational audits, consulting and governance activities to increase SOX assurance demands. Hass *et al.* (2006) further advise that nevertheless, internal audit must position itself to be actively involved with risk assessment, control and governance. Given the regulatory requirements in the US that has absorbed approximately 50 percent of internal audit limited resources as noted above, resource allocation has become a key activity of the CAEs, who need to take full advantage of new technologies such as continuous auditing and software innovations in internal audit department management. There have been a number of studies that have investigated the varying objectives and functions within the IAA and have found that internal auditors tend to assume positions which are in the best interest of the employer (Brody and Lowe, 2000).

Hermanson *et al.* (2005) examined changes in internal auditing post the Enron and WorldCom disasters and the related legislative and media focus on internal control and corporate governance in the USA. They gathered data from 271 mid-sized US public companies and found that internal audit budgets, staffing levels, meetings with the audit committee and also meeting length increased markedly during this time. However, as found by Hermanson *et al.* (2005) and Hass *et al.* (2006), much of the increased resources were SOX Section 404 driven, whereby management must prepare an annual report assessing the effectiveness of their company's internal control over financial reporting. This compliance role is an area where internal auditors are ideally qualified to provide management with the assurance they seek, but it arguably prevents them devoting resources to the broader issues supporting good corporate governance. Based on the above studies, it would be interesting to see how the IAA has evolved and what changes have taken place in the internal audit objectives and functions. This leads to the second research question:

RQ2. What are the predominant internal audit objectives and the related functions?

Furthermore, Spira and Page (2003) found that in the UK the publication of the Turnbull Report represented a radical redefinition of the nature of internal control as a feature of corporate governance, explicitly aligning internal control with risk management. They demonstrate that developments in corporate governance reporting requirements offer opportunities for the appropriation of risk and its management by groups wishing to advance their own interests, and illustrate this by a review of recent changes in internal audit. Paape *et al.* (2003) looked at the relationship between internal audit and corporate governance issues among the top listed companies in the European Union (EU) and found there were some major differences in the way internal auditors operate in the EU. Generally they see their role as supporting traditional internal audit areas rather than taking a lead in more contemporary issues such as corporate governance. As suggested by Coram *et al.* (2008), one way to evaluate the work of internal auditors is to examine how well they detect errors within an organization and there has been limited research on this topic. An early study showed that the magnitude of errors requiring adjustment by the external auditor have been found to be substantially lower for companies that had an IAA compared to those that did not have one (Wallace and Kreutzfeldt, 1991).

Church *et al.* (2001) claim that when considering fraudulent financial reporting, internal auditors believe that fraud is the reason for an unexpected difference in income when income is greater than expected and when debt covenants are restrictive, conditioned on income to be greater than expected. As indicated by The IIA Standard 2120.A2 (IIA, 2009), the IAA must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk. The IAA must also evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations and information systems, regarding the reliability and integrity of financial and operational information (Standard 2130.A1: (IIA, 2009). The next research question attempts to assess the role of internal auditors in relation to financial reporting risks:

RQ3. What are the financial reporting risks and issues faced by internal auditors and how are they addressed?

Colbert (2002) observes that the international standards on auditing require external auditors to communicate with their client's governance body regarding significant matters which come to the auditors' attention during the engagement. Similarly, the authoritative Practice Advisories issued by the IIA, mandate that internal auditors discuss certain items with the board. Thus, the body or board responsible for good governance should be receiving information from both external and internal auditors. A comparison by Colbert (2002) of the international external auditing and the internal auditing standards shows that some information received by the governance body/board is similar. However, much is unique. Thus, both groups of auditors can help the board in achieving its objective of guiding the entity to carry out its mission effectively and efficiently and in accordance with good corporate governance practice. A recent study by Stewart and Subramanium (2010) gives an overview of literature pertaining to the objectivity and independence of IAA and highlights key literature in this area and potential research opportunities. This study indicates that there is very little research which investigates the relationship between the IIA Standards and how they are used in performing the internal audit function. This leads to the next research question:

RQ4. How do internal auditors perform their tasks and to what extent are the IIA Standards used?

Research method

The data for this study were obtained from the survey by Leung *et al.* (2004). An online survey was conducted with the CAEs in Australia, defined as those who have the ultimate responsibility for the IAA within organizations. Through its well-established network amongst internal auditors, the IIA – Australia assisted in compiling a database of CAEs, including those who were not currently members of IIA – Australia at the time the research was undertaken. The database consisted of 397 names with usable e-mail addresses that formed the basis of the sample frame in this study. E-mails were sent to all 397 addresses, providing the participants with survey user identities, passwords and simple instructions for accessing and progressing with the online survey. A questionnaire was developed based on an adaptation of the earlier study by Cooper *et al.* (1996). Respondents were asked questions under the role and accountability framework existing within their organization, addressing issues such as governing charter, internal audit staff, objectives and workloads, reporting relationships and independence, relevance of the internal audit process and risk management. They were also asked about the perceptions of the effectiveness of the internal audit process (including role effectiveness and recognition, performance and corporate governance issues), and also personal and organizational profile. The survey covered an extensive range of questions and consists of the following parts, as depicted in Table I.

Of the 397 surveyed, there were 85 usable responses representing a 21.4 percent response rate. The researchers are satisfied that, judging from typical response rates to research of a similar nature, the response rate is reasonable and that the responses reflect a satisfactory representation of the views of CAEs (Burnaby and Hass, 2009; Goodwin-Stewart and Kent, 2006). Respondents were given the opportunity to answer the questions over a two-month period and they could also amend their own responses while the survey was still open. It is believed, therefore, that the online survey results represent the considered views of a reasonable sample of CAEs.

Data analysis and discussion

In analysing the data, we have attempted to critically assess the status quo of internal auditors in Australia, with a view to determining the potential risks and challenges they face in their role. The analyses and related issues are discussed in the following order: accountability structures and relationships internal audit objectives practice and performance of the IAA with the application of the

IIA Standards and financial risks and other issues. We also examine how internal auditors can meet some of the challenges in the changing corporate governance scene:

RQ1. What are the accountability structures and the management relationships of internal audit?

The majority of CAEs' reporting responsibilities extended to the audit committee or board level (26 percent to audit committees only, 29 percent to CEOs and audit committees and 22 percent to a combination of management and boards, i.e. 77 percent report to board level) but 23 percent still had a reporting line only to management (i.e. 19 percent to CEOs and 4 percent to CFOs). Further analyses show that for those CAEs who reported to audit committees only, the majority of the reports focussed on internal control (81 percent) and risks (57 percent), while 43 percent reported on compliance, 29 percent reported on corporate governance issues and only 19 percent reported on financial reporting matters. Reports on risks, compliance and financial matters increased noticeably when the CAEs reported to both CEOs and audit committees, as shown in Table II.

In considering the nature of accountability, an investigation into the frequencies (regularly, *ad hoc* or never) and formats (detailed analytical, summary only or report by exception only) of reporting by CAEs also show an interesting scenario. The key reports that were required by CAE's in most cases were the internal controls report, risk assessment report, compliance report and the information system report; while the corporate governance report was mostly presented in an *ad hoc* manner. A majority of the CAE's stated that a report on the financial reports was usually never required of them (43 percent) while approximately 30 percent stated that it was required in an *ad hoc* manner. In relation to the format of the reports presented, the internal control report, risk assessment report and the compliance report were stated as reports that were mostly presented in a detailed analytical manner, while all other major reports were mostly presented as a summary. These responses seem to indicate that, in most organizations, internal controls, risk assessment and compliance were the key focus.

A correlation analysis shows that the frequency and reporting format on corporate governance matters are significantly related to those of internal controls, risk assessment and compliance. On the other hand, compliance is significantly related to most reports, including financial reporting matters, internal controls and corporate governance (Table III). The following table gives an overview of the descriptive statistics and correlation analysis of the frequencies and formats of key internal audit reports. While 77 percent of the corporate governance reports were addressed to either the audit committee or the audit committee and CEOs/CFOs, 21 percent of these reports were addressed to management (CEOs or CFOs) only.

In determining the perception of the CAEs in relation to the effectiveness and performance of the internal audit process, a correlation analysis was conducted between the identified factors. In the questionnaire, the CAEs' were asked on the level of access to the CEO and the chair of the audit committee. The level of access was measured using various degrees of type of access, together with the time frame of the access. A weight was given to each answer, the highest weight for most frequent and lowest to the least frequent mode. A combined score was given to each answer and used in the analysis. The other determinants identified within the questionnaire gave a score from 1 to 7 (1 being strongly disagree and 7 being strongly agree) to a number of statements measuring the perceived effectiveness of the internal audit process.

When CAEs were asked about the perceptions of their roles, positive and statistically significant relationships were found between CAEs' perceptions of their effective oversight in key operations the degree of relevance and timeliness of reporting information and whether recommendations were considered and implemented. CAEs also felt that they could significantly influence key management decisions on matters concerning risks and controls. Also, consideration and implementation by the board/CEOs on internal audit recommendations was significantly and positively correlated to CAE's access to CEOs. Whether CAEs could influence key management decisions was also found to be significantly and positively correlated to their access to the chairs of the audit committees (Table IV, Panel A).

In terms of CAEs' views of the effectiveness of their accountability framework, those CAEs who would like to be more involved with corporate governance matters had lesser access to both the CEOs and the chairs of the audit committees. They strongly felt they still needed management support and that their audit committees could be more proactive. The significant correlation between the views that CAEs needed more support from key management and the perceptions that audit committees could be more proactive, demonstrate the issue of relationships between the CAEs, the CEOs and the audit committees. It is arguably reasonable and to be expected that CAEs were generally found to have better access to CEOs than to audit committees or the board. The use of non-executive directors on the main board and committees was prevalent and the chairpersons of the board are mostly non-executive. CAEs' impressions about whether they were regarded as having a significant role in corporate governance were dependent on their access to CEOs and the chairs of the audit committees. In turn, they believed that in order to add value to corporate governance, direct access to the audit committees was dependent on the personality and calibre of the board, and whether the IAA was given sufficient status in the organization (Table IV Pane B).

Moreover, when asked if the CAEs met with either CEOs or audit committees on various matters concerning internal audits, a significantly higher percentage of CAEs met with CEOs rather than with audit committees on staffing issues, resourcing and audit quality reviews. In general, CAEs tend to meet more often with CEOs on most matters. However, statistical analyses on possible correlations between access to CEOs and the chairs of audit committees, and that of the perceptions of CAEs regarding their role, show further evidence that such access has a significant impact on the effectiveness of CAEs. It is also worthwhile to note that there was a strong and significant correlation between CAEs' access to CEOs and to the chairs of the audit committees, suggesting that CEOs were always involved when CAEs met with the chairs of audit committees.

These analyses highlight that while most CAEs report to audit committees and boards, the effectiveness of the role of CAEs is perceived to be dependent on access to, and the quality of, the personnel in key management and at board level. Different forms of access, and the perceived support for CAEs, impact on the manner of reporting by the CAEs. Although there is a significant move towards better practice to ensure independence of internal auditors in terms of their reporting responsibilities, the survey results demonstrate a relatively closer relationship between CAEs and CEOs than with audit committees. Moreover, the strong correlation between access to CEOs and to the chairs of audit committees, suggest that the CAEs' access to audit committees might be subject to the CEOs' inclusion in audit committee meetings:

RQ2. What are the predominant internal audit objectives and the related functions?

Internal audit staff had a variety of workloads. Based on an average percentage of their time spent on different tasks, Figure 1 shows the weighting of internal auditors' workloads.

It is apparent that internal auditors spend a substantial amount of their time on internal control matters, management and operational audits, systems assurance and business strategic risk matters. Notably, however, corporate governance issues did not rank highly. The work performed by internal auditors is not only multi-faceted, but is also extensive and complex in nature. The next section on audit objectives is therefore pertinent in evaluating the key objectives seen as important by CAEs.

Respondents were asked to rate the level of importance of different audit objectives, which were applicable to their own circumstances. The answers to this group of questions provide an insight into the perceptions of respondent organizations about the role of their IAAs. Respondents were given a scale of 1-7, in which to indicate the least (1) to the most important (7) audit objectives. Table V reports the mean of each audit objective, together with the percentages of those who gave the last two extreme ratings (i.e. 6 and 7 for the most important; 1 and 2 for the least important) for each objective.

Table V reports that the internal audit objectives generally focussed on internal controls and risk management. On the other hand, complying with information technology security measures, satisfying audit committee requirements and dealing with corporate governance issues were ranked more important than other financial objectives. Other notable objectives were the application of IIA Standards and disclosure and earnings measurement, all of which were regarded as relatively less important than others. In view of the financial scandals in which accountants and auditors have been involved in recent years, further consideration is necessary to ascertain the role of internal auditors in preventing or assessing financial reporting risks, such as earnings management. The reporting relationships and independence of CAEs in their organizations are next examined, in order to evaluate the position of internal audit in the governance process.

As shown in Figure 1 and Table VI, internal auditors spent most time on the following five key tasks:

1. internal control evaluation;
2. management and operations audit;
3. systems assurance;
4. business strategic risk assessment; and
5. internal consultancy.

On the other hand, the five most important internal audit objectives indicated by CAEs, were:

1. monitoring the effectiveness of internal control;
2. risk assessment and management processes;
3. procedural compliance including IT systems integrity;
4. audit committees' briefs; and
5. corporate governance issues.

The internal auditors' focus on controls, risks and system compliance, as evidenced in the positive relationships, suggests that these are the areas of their role in corporate governance in which the audit committee's requirements are met. However, the significant negative correlations found in relation to the time spent on systems assurance, business strategic risk assessment and internal consultancy, uncover certain inconsistencies. It appears that internal auditors might have the perception that the time spent on evaluating systems, strategic risks and providing internal consultancy are either of less importance than other objectives, or that such areas of work are not considered by them in the overall audit framework.

Moreover, the time spent on systems assurance was found to be negatively correlated to other aspects of their tasks and audit objectives, albeit not statistically significant. An exception to this is that the time spent on systems assurance is positively related to the time spent on internal consultancy (not statistically significant). This shows that some internal auditors carry out internal consultancy in the form of providing systems assurance. The negative correlation between internal control evaluation and management audit is considered reasonable, as the two tasks can overlap, especially in the public sector. The above findings also reinforce the fact that internal auditors are concerned with aligning key audit objectives to satisfying audit committees' briefs and corporate governance issues, although such objectives are apparently not afforded the required time or resources:

RQ3. What are the financial reporting risks and issues faced by internal auditors and how are they addressed?

Table VII shows the result of CAEs' experience of specific financial reporting risks in the preceding financial year. A significant percentage of respondents have encountered financial reporting and earnings measurement issues. Nearly all financial reporting risks, identified from the earnings management literature, were experienced by over 50 percent of the respondents. The five matters with the highest percentage of occurrence are: asset valuation disclosures capital write-offs confidentiality issues and conflict of interest problems.

Most of the financial reporting issues and risk areas are concerned with financial reporting compliance, disclosures, transparency of earnings measurement, risk management and internal controls. When compared with the importance placed by internal auditors in terms of their related audit objectives, the following relationships were found.

Significant positive relationships are apparent between the importance of the audit objective of compliance matters in financial reports, with the experience of CAEs regarding asset valuations and capital write-offs. The occurrence of capital write-offs also is a significant positive relationship with the objective of ensuring the transparency of earnings measurement. Occurrences concerning accruals accounting have a significant and positive relationship with the importance of internal audit objectives regarding fraud and investigations, meeting the requirements of external auditors, and dealing with corporate governance issues. Significant and positive relationships are also found in the experience regarding liability restatements and disclosures and the internal audit objectives of meeting external auditors' requirements. All the financial reporting issues encountered by the CAEs show significant positive correlations with each other.

Financial reporting risks and issues relating to earnings measurement have been experienced by a majority of internal auditors. The more important the internal audit objectives on compliance, the more likely financial reporting problems were found. The more important were the transparency of earnings measurement methods, the higher the occurrence of capital write-offs. These may mean that the occurrences of such financial reporting issues have a direct impact on the audit objectives, or, had such audit objectives been regarded as more important, a higher rate of occurrences may result. Valuation of assets and capital write-offs was mostly regarded by CAEs as compliance matters for the financial report. Particular attention is given by CAEs to accruals accounting, which is considered as a fraud-related issue and is viewed by the CAEs as important for corporate governance. The above relationships also suggest that internal auditors tend to view accruals, liability restatements and disclosures, as assurance matters requiring attention by external auditors:

RQ4. How do internal auditors perform their tasks and to what extent are IIA Standards used?

Table VIII reports that only 36 percent of internal auditors claimed that they partly or fully use the IIA Professional Practice Standards on quality assurance and improvement, and 44 percent said they partly or fully used the Performance Standards for *Risk-based Planning.* About 46 percent of internal auditors admitted they used the Standards on *Reporting Policies* and 66 percent said they applied the Code of Ethics.

To gain further insights into the extent of the application of IIA Professional Practice Standards, the responses to the questions relating to each key standard were tested using the Spearman's rho non-parametric correlations test. The extent of application of all IIA Professional Practice Standards is significantly and positively correlated to one another, indicating that internal auditors have a consistent view about all the IIA Professional Practice Standards with respect to their application. There is not a single standard that was either used to a greater or lesser extent.

There is no significant relationship between any of the IIA Professional Practice Standards and the time spent on the key tasks performed by internal auditors. That is, the key tasks were likely to have been performed without any significant application of the IIA Professional Practice Standards. This suggests that internal auditors might have been using their own in-house standards, or that the IIA Standards were viewed to be inappropriate for use in the circumstances. Significant negative relationships exist between the time spent on management and operations audit and the usage of the

IIA Professional Practice Standard on quality assurance and improvement. This is also the case with the IIA code of ethics and rules of conduct. This suggests the standards are perceived by CAEs as not being directly relevant to the nature of the management and operations audits performed.

Tests were carried out to identify any possible relationship between the extent of the application of IIA Professional Practice Standards, the importance of internal audit objectives, and the format of internal audit reports. It was found that the key internal audit objectives of risk assessment and management, and monitoring the effectiveness of internal controls, do not have any significant relationship with the extent of applications of IIA Professional Practice Standards. The importance of the internal audit objective of applying IIA Attributes and Performance Standards (ranked eighth in the list of audit objectives), has a direct and positive relationship with internal auditors' indication of the extent of usage of such standards. This suggests that internal auditors are somewhat cautious about applying the IIA Professional Practice Standards as application was limited.

However, the importance of the corporate governance objective is recognised positively in its relationship with the importance placed on the internal audit objective of the application of IIA Professional Practice Standards. These include the standards on risk-based planning, approvals and resource management, and reporting policies. This is the same in respect to the internal audit objective on risk assessment. However, with respect to the frequency or format of internal audit reports, no significant relationships were found between the frequency, or the format, with the application of the IIA Professional Practice Standards. The above results suggest that while internal auditors were agreeable that the IIA Standards are important to achieving the objective of ensuring good corporate governance, the actual application of the Standards tends to be unrelated to the performance of internal audit tasks.

Conclusions

In conclusion, the following discussion focuses on how the research findings highlight some key implications, which the profession of internal auditing will need to address.

In relation to the accountability structure, the IIA Standards for Professional Practice requires that the CAE should report periodically to the board and senior management (Performance Standard 2060). In reporting on the HIH Insurance collapse in Australia, Owen (2003) suggested that there should be a second reporting line so that internal auditors report to the board, or its committee, regarding concerns on risks and internal control. While there is an increasing demand for internal audit functions (the Australian Stock Exchange Corporate Governance Principles and Recommendations “encourages” the establishment of internal audit functions), the research shows that CAEs' reporting lines are diverse and inconsistent. This can be more complex in multinational companies where CAEs first report to functional heads, then to the senior management and the board. While 56 percent of CAEs' reporting lines involved the audit committees and 79 percent had “ready” access to the audit committees, the presence of the CEOs in almost all cases of contact compromise the otherwise direct communication between the CAE and the audit committee, especially when it is warranted.

On the other hand, perceptions of the CAEs strongly endorse the significance of access and communication with the right calibre people at the right level of the organization. In order to provide relevant, timely and complete information for the board and senior management, CAEs should have a clear reporting role directly to the audit committee of the board. While the CEO should be kept informed and should participate whenever appropriate in discussions/meetings, the audit committee should have direct access to the CAE, without the CEO's presence. A close relationship between the CAE and CEO, rather than with the audit committee, can potentially result in the risk of intimidation or management pressure on the CAE.

Addressing the internal audit objectives and IAA, internal auditors' responsibilities, as revealed by the research, are wide ranging. While internal audit objectives have been established with a focus on controls, risks and governance, the study has highlighted the fact that there is a lack of correlation between the tasks performed by internal auditors and the important internal audit objectives, with the exception of internal control and risks. The results also suggest that internal auditors have been providing an internal consulting and advisory role in matters concerning IT systems, strategic risks and financial issues.

If internal auditors are to build their relationships with management and in the current environment proactively contribute to good corporate governance, they need to define how, and in what way, this can be done. In regard to corporate governance processes, the results of the research indicate that issues surrounding internal control, risk assessment and management processes are regarded as the key factors for internal audit to make a worthwhile contribution. Such matters are reported frequently and mostly in detail, with a view of ensuring compliance with established policies and regulations. Corporate governance issues are also seen to be a factor in satisfying the requirements of audit committees. Financial reporting issues are not seen as a significant matter of concern to the internal auditor and are generally viewed as issues to be covered by the external auditor. While the IAA could be entrusted with providing senior management and the board with relevant and timely information, internal audit objectives should primarily focus on the requirements of good governance mechanisms. Good governance mechanisms include systems which ensure integrity of information flow, adequacy of risk assessment and management processes, organizational communication and approval, effective deployment of resources, management of financial reporting procedures, timeliness of reporting and compliance with relevant legislation and standards.

Internal audit has developed significantly in the past decade. The definition of internal auditing stipulates the requirements of a systematic and disciplined approach to be adopted by internal auditors in ensuring the effectiveness of internal control, risk management processes and governance. Good corporate governance promotes open dialogue and communication, while ineffective corporate governance gives rise to conflicts and lack of transparency. Internal auditors are in a position of trust and must be seen to maintain integrity and independence in their performance and at the same time maintain good relationships with management. Ethical integrity is also an essential skill required of internal auditors. In particular, the CAE, must be capable of identifying ethical issues, investigating the full facts, consider such issues in the context of ethical principles and standards, and warn management and the board with regard to the risks. The significance of this is apparent when assessed against the potential reputation risk to an organization. Accordingly, it might even be appropriate to consider making internal audit the champion of an organization's policy pertaining to its code of conduct. Other risks include, for example, general business risks, compliance and legal risks, risks of fraudulent activities and systems failures.

The research also highlights the lean and relatively senior profile of internal audit in Australia. Internal auditors have extensive accounting and auditing experience and are likely to be in the latter part of their careers. CAEs have a strong perception that their role in contributing to good corporate governance is fulfilled through their work on internal controls, risks and compliance but there is a desire to be more actively involved in the overall governance processes. Owing to the diversity of tasks they cover, some internal auditors are able to be innovative, and are more actively involved in internal consultancy and advisory matters, while others are more focused on compliance work.

Internal audit is in a changing landscape. Public debate, media scrutiny and government intervention have never been more closely aligned on the need for lasting change in governance and management practices, as seen by the reaction to the Enron and WorldCom scandals and more recently the corporate collapses during the global financial crisis. This offers a limited opportunity for the internal audit profession to be at the vanguard of the change agenda, or alternatively be part of an outcome determined by others. The internal audit profession can build upon its inherent strengths and address any apparent areas of shortfall. Internal auditors are positive about their role in contributing to good corporate governance and the value of their work is generally appreciated by management, the board and the organization. However, there is some misalignment between the aspirations of internal auditors to contribute to good corporate governance and the work programs they currently undertake. The multiple and complex tasks covering both compliance and consultancy work performed by internal auditors, may also result in confusion about their role.

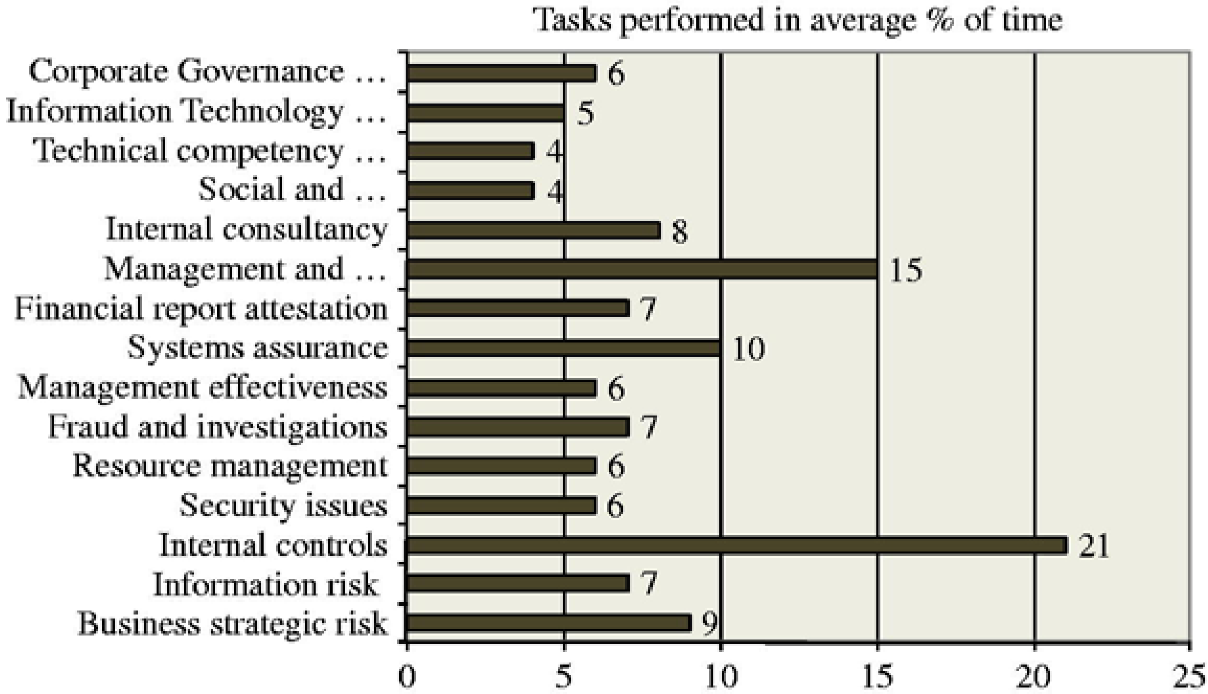

Figure 1*The average percentage of time spent on various tasks by internal audit staff*

Nature of questions	Questionnaire references
Role and accountability framework	
Governing charter	1, 2
Internal audit staff	3, 4
Internal audit objectives	5-19
Internal audit workload	20
Reporting relationships and independence	21, 28, 30-33
Internal audit definitions, application and perceptions	
Internal audit risk management and financial reporting issues	22-27, 35
Perceptions of the effectiveness of internal audit	29, 34, 36
Role effectiveness	37, 38
Role recognition	39
Performance	40
Corporate governance processes	41
Personal and organizational profiles	42-53

Table I.
A summary of the online survey questions

Table I*A summary of the online survey questions*

Table II. Percentages of regular reports and to whom they are made

Reporting to	Regular reports by internal audits in percentage[a]				
	Financial report	Internal control	Risk assessment	Compliance	Corporate governance
Audit committees only	19	81	57	43	29
CEOs + audit committees	30	87	78	78	30
Audit committees + others	24	71	65	53	29
CEOs only	60	80	47	80	40
CFOs only	33	100	67	33	33

Note: [a]The percentages do not add up to 100 because multiple reports were produced by internal auditors

Table II*Percentages of regular reports and to whom they are made*

Table III. Correlation analysis on the frequencies and formats of the major IAA reports

	Internal control reports	Risk assessment reports	Compliance reports	Corporate governance reports	IAA report on financial report format	Internal controls report format	Risk assessment report format	Compliance report format	Corporate governance report format
IAA report on financial reports	0.16	0.13	0.28^{**}	0.13	0.17	-0.22^{*}	−0.10	−0.02	0.08
Internal control reports		0.12	0.25^{*}	0.22^{*}	−0.19	0.18	−0.05	−0.07	0.01
Risk assessment reports			−0.06	0.29^{**}	−0.10	−0.17	0.29^{**}	0.01	0.13
Compliance reports				0.28^{**}	0.00	0.11	0.08	0.37^{**}	0.23^{*}
Corporate governance reports					−0.03	−0.12	0.06	−0.04	0.32^{**}
IAA report on financial report format						0.31^{**}	0.26^{*}	0.32^{**}	0.30^{**}
Internal controls report format							0.45^{**}	0.38^{**}	0.28^{**}
Risk assessment report format								0.46^{**}	0.50^{**}
Compliance report format									0.58^{**}

Notes: $^{*}p < 0.05$ (one-tailed); $^{**}p < 0.01$ (one-tailed)

Table III*Correlation analysis on the frequencies and formats of the major IAA reports*

Panel A: perception on efficiency

Descriptive statistics:	*n*	*Minimum*	*Maximum*	*Mean*	*SD*
The internal audit function has effective oversight in all key operations	70	1	7	5.46	1.48
IAA provides information for the board and AC to make decisions on financial matters	69	1	7	4.52	1.80
Internal auditors maintain integrity and objectivity	70	2	7	6.27	0.96
IAA provides advice and resources to others	70	1	7	5.46	1.54
Reports generated by internal audit are always timely	70	3	7	5.06	1.18
Recommendations by internal auditors are usually considered and implemented	70	2	7	5.60	1.10
Internal audits are usually performed with an emphasis on risks and controls	69	2	7	6.19	0.97
Internal audits carried out are often only for regulatory compliance	70	1	7	3.14	1.64
Influence key management decisions on matters within my expertise	70	2	7	5.71	1.18

Correlations	*Access to audit com. chair*	*The internal audit function has effective oversight in all key operations*	*A provides information for the board and AC to make decisions on financial matters*	*Internal auditors maintain integrity and objectivity*	*IAA provides advice and resources to others*	*Reports generated by internal audit are always timely*	*Recommendations by internal auditors are usually considered and implemented*	*Internal audits are usually performed with an emphasis on risks and controls*	*Internal audits carried out are often only for regulatory compliance*	*Influence key management decisions on matters within my expertise*
Access to CEO	0.53**	0.16	0.19	0.26*	0.15	0.00	0.13	0.12	−0.08	0.35**
Access to Audit Com. Chair		0.09	0.17	0.24*	0.18	−0.08	0.21*	0.07	−0.09	0.31**
The IAA has effective oversight in all key operations			0.13	0.12	0.28*	0.10	0.21*	0.13	0.10	0.40**
The IAA provides information for the board and AC to make decisions on financial matters				0.07	0.29**	0.21*	0.22*	−0.01	0.24*	0.11
Internal auditors maintain integrity and objectivity					0.31**	0.175	0.11	0.17	0.07	0.25*
IAA provides advice and resources to others						0.42**	0.50**	0.15	0.01	0.54**
Reports generated by internal audit are always timely							0.27*	0.30**	−0.08	0.18
Recommendations by internal auditors are usually considered and implemented								0.14	−0.02	0.59**
Internal audits are usually performed with an emphasis on risks and controls									−0.14	0.11
Internal audits carried out are often only for regulatory compliance										0.07

Panel B: Perceptions on performance

Descriptive statistics	*N*	*Minimum*	*Maximum*	*Mean*	*SD*
CAE is actively involved with the board/audit committee in the organization's governance	69	1	7	4.23	1.90
Still require support of key management in order to be effective	70	1	7	5.79	1.50
Audit committee can be more proactive and involved	69	1	7	5.74	1.50
CAE is regarded by the board to have a significant role in corporate governance	70	1	7	5.66	1.26
IAA can only add value to the governance process through direct access to the audit committee	68	1	6	4.10	1.64
Effectiveness of corporate governance is dependent on the personality and caliber of the board	67	1	6	3.15	1.49
To be effective, internal audit must be provided with sufficient status in the organization	70	3	6	5.20	0.88

Correlations	*Access to audit com. chair*	*CAE is actively involved with the board/ audit committee in the organization's governance*	*Still require support of key management in order to be effective*	*Audit committee can be more proactive and involved*	*CAE is regarded by the board to have a significant role in corporate governance*	*IAA can only add value to the governance process through direct access to the audit committee*	*Effectiveness of corporate governance is dependent on the personality and caliber of the board*	*To be effective, internal audit must be provided with sufficient status in the organization*
Access to CEO	0.53**	−0.30**	−0.17	0.33**	0.33**	−0.20	−0.26*	−0.02
Access to audit com. chair		−0.19	−0.22*	0.23*	0.46**	−0.03	−0.22*	0.01
CAE is actively involved with the board/audit committee in the organization's governance			0.33**	−0.07	−0.10	0.07	0.21*	0.05
Still require support of key management in order to be effective				0.09	−0.10	0.06	−0.03	0.23*
Audit committee can be more proactive and involved					0.44**	0.02	−0.10	0.18
CAE is regarded by the board to have a significant								

Table IV*Correlations between access to CEOs and audit committee chairs and CAEs' perceptions*

Table V.
Importance of audit objectives expressed in mean ratings and percentages of respondents on both extremes

	n	Range	Min.	Max.	Mean	SD	Variance
1. Monitoring the effectiveness of internal control	81	4	3	7	6.33	0.80	0.65
2. Risk management and assessment	81	5	3	8	5.99	1.14	1.31
5. Corporate governance issues	78	8	1	9	5.50	1.36	1.86
4. Audit committee briefs	78	6	1	7	5.50	1.36	1.86
3. Compliance with information technology security measures	80	5	2	7	5.46	1.09	1.18
6. Integrity and objectivity of financial information	79	5	2	7	5.27	1.42	2.01
7. Fraud and investigations	81	6	1	7	4.83	1.46	2.12
8. Application of IIA attributes and performance standards	78	6	1	7	4.65	1.51	2.30
10. Internal consultancy	78	6	1	7	4.54	1.59	2.54
9. Ethics and social responsibility	81	6	1	7	4.51	1.50	2.27
11. Strategic management advices	80	8	1	9	4.45	1.59	2.55
12. Adequacy of disclosure of financial information	79	6	1	7	4.33	1.74	3.04
15. External auditor requirements	79	6	1	7	3.70	1.55	2.39
14. Transparency of earnings measurement	0						
13. Compliance matters in financial reports	0						

Table V*Importance of audit objectives expressed in mean ratings and percentages of respondents on both extremes*

	Business strategic risk assessment	Systems assurance	Management and operations audit	Internal consultancy	Monitoring the effectiveness of internal control	Risk assessment and management	Procedural compliance including IT systems integrity	Audit committees' briefs	Corporate governance issues
Business strategic risk assessment	−0.01	−0.17	−0.22*	0.07	0.24*	−0.22*	−0.12	0.01	0.16
Internal control evaluations		−0.03	−0.29**	−0.17	−0.11	0.38**	−0.04	0.14	−0.13
Systems assurance			−0.17	−0.05	−0.07	−0.05	0.08	0.00	−0.28*
Management and operations audit				0.03	0.12	0.14	0.00	0.12	−0.04
Internal consultancy					0.07	−0.09	−0.29*	−0.28*	0.02
Monitoring the effectiveness of internal control						−0.05	−0.00	0.48**	0.21*
Risk assessment and management							0.24*	0.38**	0.16
Procedural compliance including IT systems integrity								0.20*	0.32**
Audit Committees' briefs									0.35**

Notes: * $p < 0.05$ (one-tailed); ** $p < 0.01$ (one-tailed)

Table VI.
Correlations between the five most time-consuming tasks and the five most important audit objectives

Table VI*Correlations between the five most time-consuming tasks and the five most important audit objectives*

Matters	Occurrence In %[a]	Occurrence In number	No action	Action required	Involved board/audit committees
Accruals accounting	48	29	21	8	4
Asset valuation	63	37	22	15	4
Materiality	57	34	21	13	5
Accounting for intangibles	56	33	24	9	2
Capital write-offs	61	37	29	8	3
Liability restatements	46	27	20	7	3
Disclosures	63	38	18	20	8
Confidentiality issues	61	37	23	14	6
Conflict of interest	61	37	23	14	6
Other matters	38	5	3	2	2

Note: [a]The percentages do not add up to 100 because multiple reports were produced by internal auditors

Table VII. Occurrences of specific financial reporting risks and subsequent actions in the last financial year

***Table VII**Occurrences of specific financial reporting risks and subsequent actions in the last financial year*

Table VIII. Application of professional practice standards in percentage of respondent organizations

IIA Standards	Minimally applied	Reference only	When required	Partly used	Fully used
Quality assurance	12	27	25	29	7
Risk-based planning standards	8	24	24	25	19
Communications standards	17	28	15	22	18
Approval and resource mgt standards	18	31	26	17	8
Reporting policies	13	28	13	18	28
Code of ethics and rules of conduct	12	16	6	18	48

***Table VIII**Application of professional practice standards in percentage of respondent organizations*

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