

## Effectiveness of the Role of Internal Audit Function: A Perception of External Auditors of Pakistan

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Internal Audit Function (IAF) is considered as an important element of corporate governance. It can contribute to good corporate governance only if it operates effectively. There are many stakeholders of IAF like Board of Directors (BoD), the firm's management, external auditors etc. All these stakeholders have their different needs and also have different perception regarding IAF. In this study, we tried to explore the perception of external auditors regarding the role and effectiveness of the IAF. For this purpose, we interviewed with eight external auditors of different audit firms. As per the findings of this study, the role of IAF includes checking the compliance and evaluation of internal controls, risk management and fraud risk management. This paper further concluded that the current role of IAF can be more effective by making IAF independent and by the induction of the personnel with right qualification, skills and relevant experience. External auditors can also get benefits from effective IAF.

**Keywords:** Internal audit function, corporate governance, external auditors, board of directors.

**JEL Classifications:** M42

### INTRODUCTION

The importance of good corporate governance has been increased since the case of Enron and currently there is an intense emphasis on it in every firm (Anderson, Christ, Johnstone & Rittenberg, 2012). Internal Audit Function (IAF) is considered as one of the integral components of good corporate governance (Soh & Bennie, 2011). The significance of IAF has been increased for the purpose of reducing fraudulent and misleading financial reporting, detection and prevention of material weaknesses (Prawitt, Sharp & Wood, 2012), improving the internal control environment and mitigation of fraud risk (Coram, Ferguson & Moroney, 2008).

Governance stakeholders mostly rely on the IAF, which increases the importance of IAF (Desai, Roberts & Srivastava, 2010). According to The Institute of Internal Auditors (IIA); audit committee, management, board of directors and audit clients are considered as major stakeholders of IAF (IIA, 2010). If these stakeholders perceive the quality of IAF is not effective, then they would not rely on the reports or information produced by the IAF (Desai, Roberts & Srivastava, 2010; Burton, Emmett, Simon & Wood, 2012). External audit is also considered as one of the keystones of corporate governance, particularly with respect to the prevention and detection of frauds and errors in financial statements (Adamec, Leinicke, Ostrosky & Rexroad, 2005; Davidson, Goodwin, Stewart & Kent, 2005). External auditor is also considered as an important stakeholder of IAF because the effectiveness of IAF leads to better quality of external audit with lower audit fee (Abbott, Parker & Peters, 2012).

According to the International Standard on Auditing (610), external auditor always evaluates IAF before using its information for audit purpose (IFAC, 2017), but the general understanding of the quality of IAF is limited. The measure of quality normally focuses on three components; competence,

objectivity and work performed (IFAC, 2017). It is very important to understand the determinants of the quality of IAF and to see how these stakeholders judge the quality of IAF. In case of better quality of IAF, confidence of external auditor increases, which can improve the efficiency and effectiveness of the external audit (Pizzini, Vargus & Ziegenfuss, 2012) and because of the time saving in external audit assignment its fee is also reduced (Abbott, Parker & Peters, 2012). A strong coordination between internal and external auditor leads to good corporate governance, which helps in minimization of chances of corporate collapse (Rusak & Johnson, 2007).

Despite increasing the role of IAF in good corporate governance, only limited researches have examined the effectiveness of this function. Gramling, Maletta, Schneider and Church (2004) suggested that consideration should be given to the party relying on the work of the IAF, whether it is the Audit Committee (AC), the external auditor and the management. The authors suggested that quality may vary according to the party which is using the work of the IAF. Because of the importance of IAF there is a need to understand the role, effectiveness and the attributes which can make IAF more effective.

The main objective of this study is to explore the perception of external auditors regarding the role and effectiveness of the IAF. This study also tries to find those attributes which can make IAF more effective, in addition to that this study explores the fact that how much IAF is helpful for external auditors.

There are different researches on the role of IAF (For example Burton, Emmett, Simon & Wood, 2012; Cohen, Krishnamoorthy & Wright, 2010; Gramling, Nuhoglu & Wood, 2012). In the past few years, many changes have occurred in the business environment after that need and challenges of the role of IAF has become broader. Currently, the role of IAF also covers the control, governance and risk management (Moeller,

2009). The IAF can add value only when it would be effective (Mihret, James and Mula 2010). Due to the wider consulting role of the IAF, it is important to measure the effectiveness of the IAF (Alzeban & Gwilliam, 2014). The work of IAF is used by external auditors which can modify audit procedures. If IAF is efficient, it can reduce the work of the external auditor and ultimately causes reduction in audit fees (Abbott, Parker & Peters, 2012). Last but not least, this study also tries to find out the attributes, which can make the role of IAF more effective.

In Pakistan it is mandatory for listed companies to have IAF in Pakistan (SECP, 2017). This study is the pioneer in the field of internal audit in Pakistan. There is not a single study regarding perception of external auditor regarding the role and effectiveness of IAF, so this study is covering this research gap by exploring the area.

### **LITERATURE REVIEW**

The role of IAF studied from different aspects in the past literature, just like Prawitt, Smith and Wood (2009) measured the association between earning management and IAF quality. The measurement of quality of IAF based on six factors included objectivity, experience, training, focus on financial work, certification and investment of the firm in IAF. They concluded that earning management is moderated by the quality of IAF. Ahmad, Othman and Jusoff (2009) explored the significance and influence of the IAF in the public sector of Malaysia. In this study data is collected from different persons, which are working in internal audit function of different organizations. They concluded that top management does not support the IAF adequately. Lin, Pizzini, Vargus, and Bardhan (2011) investigated the role of the IAF in the disclosure of material weaknesses in the internal control system of the firms. For this purpose, they used the data of 214 US firms. The Results of this study showed that material weakness disclosures are negatively associated with the education level of the people which are involved in IAF.

Another study was conducted on the role of the IAF in promoting effective corporate governance in the banks of Kenya (Changwony and Rotich, 2015). They used questionnaires to collect data and received 89 responses from respondents. They found a positive and significant role of internal audit function for promoting effective corporate governance. In Pakistan, Khan (2016) investigated the relationship of internal audit with corporate governance. In this study, data was collected from questionnaires and the results showed a significant relationship between the characteristics of internal audit quality and corporate governance.

In some other studies effectiveness of the role of the IAF was also measured. Cohen and Sayag (2010) measured the effectiveness of the IAF in Israeli organizations. They collected the data from 180 organizations. Results showed that support and priority level of the top management is the main factor which influences the effectiveness of the IAF, second main factor is the independence of the IAF. Ramachandran, Subramanian and Kisoka (2012) measured the effectiveness of the IAF in Tanzanian Commercial Banks, results showed that IAF is not a value-added activity and it is added as a mandatory

regulatory function only. There are many studies in which researchers tried to explore the attributes and characteristics, which can make IAF more effective. Coetzee and Lubbe (2014) also analyzed the efficiency and effectiveness of the IAF. They interviewed with five chief audit executives of companies, listed on the stock exchange of South Africa. They recommended that the emphasis on audit processes should be more, so IAF can be improved by adopting the risk-based audit approach. Udeh and Nwadiolor (2016) tried to evaluate the IAF in the public sector of Nigeria. They used questionnaire techniques for data collection and this study concluded that IAF is not enough effective in public sector organizations. Arena and Azzone (2009) studied the organizational factors which drive the effectiveness of the IAF, they found that characteristics of the internal audit team, internal audit processes and organizational links affect the effectiveness of the IAF.

Ebaid (2011) studied the nature and characteristics of the IAF in Egyptian firms. He analyzed the aspects of insourcing or outsourcing of IAF, interaction with external auditor and organizational settings. The results of this study are, the internal audit function of these firms is not independent and mature. Sarens, Abdolmohammadi and Lenz (2012) examined the factors which are associated with the IAF for having an active role in effective corporate governance. They used the responses of 782 chief audit executives from different US firms, found a significant role of IAF in an effective corporate governance.

Alzeban and Gwilliam (2014) assessed the factors which influence the effectiveness of the IAF. This study was conducted on the Saudi Arabian corporate sector, for this purpose they collected data from the business managers and internal auditors. This research work concluded that persons working in IAF, have lack of appropriate knowledge and training. Kien (2015) in his latest study analyzed the performance measurement of the IAF in the construction firms in Vietnam. He collected the data through reports and interviews. As per the results many organizations did not have a proper performance measurement system for the IAF. In another study by George and Konstantinos (2015) investigated the factors associated with the effectiveness of the IAF in Greek business environment. Data was collected through mailed survey and as per the results, the factors which affect the effectiveness of the IAF is quality, competence team, independence and management support.

There are also some researches regarding IAF in relation to external audit. Haron, Chambers, Ramsi and Ismail (2004) studied the criteria used by external auditors to evaluate the IAF of a company. They used the Malaysian firms' data, which is received from the auditors belonged to big-four and non-big-four audit firm. They found that while relying on the work of internal audit, external auditors use technical competence and scope of functions as the most important factors. In another study, Brandon (2010) investigated the extent of reliance by external auditors on outsourced internal audit function when internal auditor is also providing non audit services to the organization. Data was obtained from 89 auditors of different

USA audit firms. As per the results of this study, internal auditor's objectivity was negatively affected if it is also providing non audit services. In this case external auditor's reliance on the internal audit work is also affected.

## **METHODOLOGY**

This is an exploratory type of qualitative research. We used semi structured interviews for the purpose of collecting data. This method is widely used by researchers in this kind of researches (Bedard, Westermann & Earley, 2012). Due to the flexibility, semi structured interviews give researchers to explore the paths observed while during these interviews (Gendron, Bédard & Gosselin, 2004).

### **Participants**

In this study purposive sampling is used and only those persons are selected for interviews which are information rich. Participants included persons working in audit firms at senior level. We conducted interviews with seven partners of audit firms and one director of a big4 audit firm. Selecting a sample size that yields data that have a realistic chance of reaching data saturation, theoretical saturation, or informational redundancy is necessary in qualitative research. Purposive sampling is more appropriate for this (Onwuegbuzie & Daniel, 2003).

Length of the interviews was from 12 to 15 minutes each and all these interviews were conducted in Lahore from May to June 2017. A standard interview guide was used while conducting interviews.

### **Interview Questions**

Interview questions were developed with the help of literature review and by using different theories of measurement of the quality of services in different disciplines.

### **Validity and Reliability Issues**

Validity and reliability of the data are ensured by recording interviews (Cohen, Krishnamoorthy & Wright, 2010). Because it is an exploratory research, we recorded the interviews and during the interview brief notes of thoughts and ideas were also taken and right after the interview, these notes were expanded into more detail.

### **Findings and Discussions**

#### **Role of Internal Audit**

The role of IAF consists of to check the compliance and to do an evaluation of internal controls, financial risk management and fraud risk management in the firms. All the respondents agree on these roles of IAF. One of the respondents said, "*It (IAF) advises the organizations on matters such as acquisition of new ventures, evaluation of controls, whether controls are effective or not?*" Another respondent said, "*IAF does internal control evaluation and also find out the root causes of the happening of the issues.*" As per the respondents, checking the compliance of internal controls, its evaluation and advising to make them better are core responsibilities of IAF.

Regarding the risk management function of IAF, one of the respondents said:

*"When the IAF evolved in the 80s and 90s, it had no relation to risk management. It was just limited to the*

*compliance of policies and procedures. After 2000, because of growth in size and volume of businesses, IAF is supposed to check everything and play a vital role in risk management."*

Another challenge is being faced by the firms is financial frauds. As per respondents, fraud risk management is also considered as the function of IAF but detection of fraud is not the core responsibility of the IAF. They only see the fraud risk and red flags of fraud. One of the respondents said, "*IAF directly does not detect fraud, but identifies fraud risk and see the fraud from that angle, IAF sees the red flags*".

Another respondent endorsed this statement in the following words:

*"It (IAF) can detect fraud in a complete investigation and detailed evaluation of controls, but it comes in a special arrangement. Regularly they do not work for the fraud identification and detection. But when the matter arises and there is a red flag, they do identify it"*.

But as per one of the respondents, detection of the fraud is also the responsibility of the IAF, he said, "*Detection of fraud becomes the responsibility of IAF*".

#### **Current Effectiveness of IAF**

As per respondents, IAF is not performing its above roles effectively. One respondent said,

*"It is not so effective in performing above roles. Our corporate sector does not have the right perception regarding IAF"*. Another respondent said, "*In Pakistan, there should be a risk-based role of IAF, but it is not like this*".

There are many reasons behind this phenomenon like perception of businessmen about IAF, weak independence of IAF, lack of proper support of top management and considering it as a cost not a value adding function. One respondent said,

*"Businesses are family owned, if they are not family owned, like listed companies they are family dominated. IAF has limited capacity to hit management function. They are reporting to the management, the people who are supposed to be evaluated by them"*.

Another respondent said,

*"Our owners think the IAF as mere a cost. Only few people have it right perception and they want to invest on IAF"*. But one respondent identifies one exception to this reality, he said, "*In big companies like multinationals they are playing good role*".

Another respondent told about the prerequisites for effective performance of IAF. He said:

*"It depends on how much liberty and control is given by organizations to IAF through a charter which is approved by the board of directors and the audit committee. If IAF is independent and has some authority and capability in the form of right resources and right skills, then off course its role becomes very effective to manage the risks"*.

### Support of IAF to External Auditors

The nature and extent of the work of external auditors are entirely different from internal audit. But if IAF performs effectively, it helps in external audit. One of the respondents said:

*“In the organization where this function is working properly it can help external auditors. In the absence of IAF, external auditor needs to increase the extent of tests on figures”.*

Another respondent said, *“If IAF is strong and also fulfill the quality parameters, it can reduce the extent of substantive procedures performed by external auditors”.* In result of this, time span on external audit may be reduced and leads to low audit fee. Reduction in the work of external auditor depends upon the effective work of IAF and availability of all the reports to external auditors. Opinion of another respondent on this issue is reproduced here, he said:

*“If the external auditor gets a reasonable assurance that IAF is working properly and its reports are shared with external auditor which show that IAF covered those areas and their conclusion is satisfactory, then the extent of the work of external auditor would be reduced”.*

### Attributes of an Effective IAF

If the work of the IAF is highly beneficial then what attributes can make the IAF so effective? As per respondents' proper qualification and experience of internal audit personnel, training, support of top management, free communication with the board of directors and audit committee and independence can make IAF an effective function.

One of the respondents said:

*“IAF should be given some authority, charter, Terms of Reference (TOR). The board of directors assigned to the Audit Committee and Audit Committee delegates this function to IAF. This can be effective if they have right skills set which is the competencies of the staff and the diversity of the experience”.*

As per the respondents, attributes of IAF personnel depend upon the functions of the organizations and the areas which are being catered. But relevant qualification and experience are inevitable. IAF function should be led by an appropriate person having a high level of knowledge, skills and experience. One of the respondents said:

*“Above all it is a good function headed by good qualified person. The audit team of different areas must have all skills which are required to do the audit of those areas”.*

About the head of IAF function one of the respondents said:

*“The head of IAF must have the proper relevant qualification and he should regularly update his knowledge. He must know the changes in the profession and knowledge of the industry in which he is working. Industry specific knowledge is also necessary”.*

A team of IAF should consist of professionals, having relevant qualification, proper skills set and relevant diversified experience, another important skill is IT skill. As per respondents, members of IAF must have relevant knowledge of IT function and software solutions like SAP, Oracle Financial etc. One of the respondents said, *“IT and information system audit is a part of IAF. It is the skill which is highly appreciated and required in the IAF as a whole”.*

The attributes which should exist in the IAF include independence, authority, direction, free communication and support of Audit Committee (AC) and IAF should be answerable to AC only. One of the respondents said:

*“IAF must be independent. Direction should be given by the AC to IAF. IAF would not be under CEO. The IAF should be answerable to AC only. Audit plan should be approved by AC”.*

Another respondent said, *“Though IAF needs to link to the board of directors. In listed companies it happened through the AC. The IAF should have the voice at Audit Committee”.*

One of the respondents emphasized on the need to create awareness in the management of the firms regarding the effectiveness of the IAF, he said:

*“We need a cultural shift to make IAF effective. Cultural shift means a change in the perception of top management and other personnel because no one like to be criticized or checked. People have perception about both IAF and external auditor that they are criticizing them, but IAF does not do this. IAF is working for your betterment and advising you the best ways to do the work”.*

### CONCLUSION

The results of this research paper showed that the IAF is very beneficial not only for external auditor but also for every stakeholder. The role of IAF includes the checking of compliance with policies and procedures, evaluation of internal controls, risk management and up to some extent fraud risk management. The current role of the IAF is not so effective, we can make it effective by making IAF independent and strong and by the induction of the personnel with right qualification, skills and relevant experience. If the IAF performs in the organization effectively, external auditor can get help from its working and findings and it can reduce the time and efforts on external audit assignment.

### Limitations and Future Research Directions

The participants of this study selected from Pakistani environment; therefore we cannot generalize the results of the study on greater population. We conducted the research only on the perception of external auditors regarding IAF and other stakeholders which are not included in this study may have a different opinion regarding the effectiveness of the IAF. Based on this work, following are the future research opportunities:

1. In this study, semi structured interviews are used for data collection, other techniques like questionnaire and case studies can also be used in future.

2. Another study can be conducted to understand the perception IAF quality of other stakeholders which are not included in this research
3. In other research, it can also be considered that how the quality judgment of external auditors affected by sourcing arrangement of IAF?

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