The internal audit function: 
Perceptions of internal audit roles, effectiveness, and evaluation

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STRUCTURED ABSTRACT

PURPOSE The aim of this exploratory study is to provide insights into the current roles and responsibilities of the internal audit (IA) function and the factors perceived to be necessary to ensure its effectiveness. The current performance evaluation practices of IA are also examined.

DESIGN/METHODOLOGY/APPROACH Semi-structured interviews were utilised to elicit the perceptions of key corporate governance actors about the evolving role of IA, as well as IA effectiveness, in terms of its design, measurement, and evaluation.

FINDINGS The results of the study suggest significant expansion and refocus of the role of IA and perceptions of its effectiveness. However, the findings also suggest that performance evaluation mechanisms of IA have not evolved contemporaneously. The misalignment between the role and evaluation gives rise to difficulty in assessing the extent to which IA functions are meeting stakeholders’ expectations.

PRACTICAL IMPLICATIONS The findings are useful in informing the deliberations of regulators and standard setters, as well as providing a benchmark for internal auditors and audit committees. The insights are also relevant for external auditors who are required to consider various aspects of corporate governance, including the objectivity and quality of IA.

ORIGINALITY/VALUE The use of semi-structured interviews facilitates an in-depth insight and understanding of the perceptions of roles, effectiveness and evaluation of IA and adds depth to the predominantly questionnaire based survey approach of prior studies.

RESEARCH PAPER

Key words: Internal audit; corporate governance; audit committee; performance evaluation; Australia

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1. **INTRODUCTION**

In the aftermath of corporate scandals and the global financial crisis, corporate governance has received significant attention from regulators and the public. Regulatory responses have focused on increasing disclosure requirements relating to corporate governance and this has, in turn, driven increased awareness and demand for internal assurance on corporate governance processes, including internal control and risk management. Given its unique position within the organisation, the internal audit function (IAF) is well placed to provide this assurance and is an integral component of the corporate governance mosaic.

A number of recent studies (e.g. Gramling *et al.*, 2004; Carcello *et al.*, 2005; Sarens and De Beelde, 2006; Cohen *et al.*, 2010) have reported significant changes in the role of the IAF as a result of recent regulatory reforms in the U.S., U.K., and Australia (e.g. Sarbanes-Oxley Act in the U.S. in 2002). These studies call for further research into the changing nature and effectiveness of the IAF from the perspectives of key corporate governance parties in varying geographic and regulatory contexts. Calls have also been made for alternative research methods (e.g. Goodwin-Stewart and Kent, 2006) to be employed, in addition to the predominantly archival and survey approaches of prior studies, to provide an in-depth insight and extend our understanding of the roles of the IAF. The present study aims to contribute to the literature by responding to these calls.

Semi-structured interviews were used to elicit the perceptions of key corporate governance actors in relation to the evolving role of internal audit, as well as internal audit effectiveness, in terms of its design, measurement and evaluation in the current Australian context. These data will be useful in informing the deliberations of regulators and standard setters (e.g. Internal Audit Standards Board), as well as providing a benchmark for practitioners (e.g. chief audit executives and audit committee members). It has also been suggested that clarifying the roles and responsibilities of the IAF will assist its
communication with other corporate governance stakeholders such as the audit committee (AC) (AICD et al., 2008). The insights are also relevant for external auditors who are required under International Standards on Auditing (ISAs) to consider various aspects of corporate governance, including the IAF’s objectivity and quality when assessing an entity’s control environment and/or potential reliance on the work of the IAF (ISA 315 and 610). Lastly, it is hoped that the findings will prompt further consideration of current evaluation practices of IAF quality and effectiveness in meeting stakeholder expectations.

The remainder of the paper is structured as follows: Section 2 provides a review of the extant literature relating to the IAF, its roles, effectiveness and evaluation, while developing the research questions for the present study. In Section 3, the research method employed is outlined. Section 4 presents the findings, and finally, conclusions and suggestions for further research are provided in Section 5.

2. LITERATURE REVIEW AND DEVELOPMENT OF RESEARCH QUESTIONS

Increasing attention on the IAF, its expanding roles (Spira, 2003; Carcello et al., 2005), its establishment in a growing number of organisations (Arena and Azzone, 2007), and an increase in its size (Ernst & Young, 2007) have been observed over recent years. Studies have also provided support for the importance of the IAF and its ability to contribute towards quality corporate governance, through its oversight role, its improvements to the control and monitoring environment and its potential to mitigate fraud risk (Beasley et al., 2000; Coram et al., 2008). It is noteworthy that in November 2003, the U.S. Securities and Exchange Commission (SEC) approved the updated New York Stock Exchange (NYSE) listing standards. Consequently, under Rule 303A.07(d) in the Listed Company Manual (effective October 2004), “listed companies must maintain an internal audit function to
provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control”.

2.1 INTERNAL AUDIT FUNCTION AND ITS ROLES

Although there are presently no mandatory requirements for companies to have an IAF in Australia\(^3\), specific references are made in the Australian Securities Exchange (ASX) Corporate Governance Council (CGC) Guidelines (2010) to the IAF and its role. The ASX CGC Guidelines advise that an IAF will generally carry out analysis and independent appraisal of the adequacy and effectiveness of a company’s risk management and internal control system. Similarly, the professional bodies (AICD \(\text{et al.}, 2008\)) suggest that the IAF acts as an agent for the AC and provides independent and objective assurance to the AC on internal corporate governance, risk management, internal control and compliance.

Despite increased corporate governance disclosure requirements (e.g. AC charter), no similar requirements exist for the IAF or its charter. Given that companies are not required to make disclosures about their IAF charter (if one exists), researchers are limited in their ability to examine the roles and responsibilities of the IAF using publicly available information. Consequently, prior research (e.g. Carcello \(\text{et al.}, 2005\); Castanheira \(\text{et al.}, 2010\)) into the roles of the IAF has been mainly facilitated through surveys of chief audit executives (CAEs). These studies indicate that “the nature of internal audit activity today typically includes risk assessment, control assurance, and compliance work, all of which map directly into corporate governance” (Gramling \(\text{et al.}, 2004\), p. 196). Other areas include consulting to management, and the performance of quality, health, safety and environmental audits.

Although the recent regulatory reforms in Australia have not directly addressed the role of the IAF, reforms addressing issues such as the independence requirements of the

\(^3\) The Commentary to Recommendation 7.2 states that a company should consider having an internal audit function, but that an alternative mechanism may be used to achieve the same outcome depending on the company’s size and complexity and the types of risk involved.
external auditor and the duties and greater compliance requirements of the AC have inevitably resulted in an expanded role of the IAF (Hermanson, 2002; Carcello et al., 2005; CPA, 2005; Arena and Azzone, 2007; Nagy and Cenker, 2007).

In light of the evolving role of the IAF (Spira, 2003; Carcello et al., 2005), and specific calls for more comprehensive descriptions of the type and extent of work the IAF undertakes (Carey et al., 2000), this study investigates the perceptions of key corporate governance stakeholders, namely audit committee chairs and CAEs on the role of the IAF by addressing the following research question:

**RQ1**: What are the roles and responsibilities of the IAF and how have they changed in recent years?

### 2.2 Effectiveness of the Internal Audit Function

Several studies have examined IAF characteristics (Paape et al., 2003; Leung et al., 2004; Arena and Azzone, 2007). A number of these studies have related IAF characteristics to the effectiveness of its function. For example, in assessing the IAF’s contributions to financial reporting quality, CAEs’ evaluations are found to be positively related to the resources available to the IAF, including its size, and the level of expertise within the function (Mat Zain et al., 2006). The status and position of the function and of the CAE have also been found to be positively related to CAEs’ self-evaluations of their performance (Leung et al., 2004). In investigating the effectiveness of in-house vs. outsourced functions, Coram et al. (2008) found that having a full or partial in-house IAF increases the likelihood of detecting and self-reporting fraud. The present study complements prior survey research by examining the notion of perceived effectiveness of the IAF through interviews with audit committee chairs and CAEs. Thus the construction of perceived effectiveness is examined by addressing the following research question:

**RQ2**: What are the key factors perceived to contribute to IAF effectiveness?
2.3 Evaluating the Internal Audit Function

There are several aspects relating to the evaluation of the IAF within the *International Standards for the Professional Practice of Internal Auditing* (ISPPIA). Attribute Standard 1300 provides that the CAE must develop and maintain a quality assurance and improvement program that covers all aspects of the IAF’s activity and continuously monitors its effectiveness. This program is to include periodic internal and external quality assessments and ongoing internal monitoring. Internal assessments should include ongoing reviews of the performance of the IAF’s activity and periodic reviews performed through self-assessment or by other persons within the organisation with knowledge of IAF practices and the ISPPIA (Attribute Standard 1311). External assessments should also be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organisation (Attribute Standard 1312).

Ernst & Young (2007) report that the top two metrics used in the measurement of IAF effectiveness are the completion of audits in comparison to an IAF plan, and the length of time for issuing IAF reports. The survey findings also indicate that in order to demonstrate the value and relevance of the IAF, value-tracking (cost savings and/or revenue enhancements) should be used as a mechanism to measure the IAF’s support of key business initiatives. However, the Ernst & Young (2007) survey results indicate that 51% of respondents do not perform any value-tracking of the IAF, and only 13% measure the value of the function based on actual cost savings.

Despite increasing attention to the IAF’s role within corporate governance, only limited research has examined the effectiveness of its function. In assessing the quality and effectiveness of the IAF, Gramling *et al.* (2004) suggest that consideration should be given to the party relying on work of the IAF, whether it be the AC, the external auditor and/or
management. The authors suggest that quality may vary according to which party is using the work of the IAF.

Research to date has predominantly focused on the quality of the IAF from the external auditor’s perspective (DeZoort et al., 2001). Factors such as independence, objectivity and proficiency have been used as indicators of quality of the IAF (e.g. Messier and Schneider, 1988; Krishnamoorthy, 2002; Suwaidan and Qasim, 2010) and suggest that the extent of reliance the external auditor places on the work of the IAF is positively related to these factors.

Consequently, it has been acknowledged that evaluation of the IAF’s performance needs to consider a wider set of measures, including the consideration of quality from the perspective of other actors in the corporate governance mosaic (Coram et al., 2008). Furthermore, in evaluating the IAF, it is important to be cognisant of the influential role the AC has in determining the quality of the IAF, given its resource allocation and oversight responsibilities pertaining to the IAF (Cohen et al., 2004; Gramling et al., 2004).

There is thus significant potential and the need for further research into the performance evaluation practices of the IAF. As noted by Arena and Azzone (2007, p. 110), “if companies are investing increasing efforts in developing internal auditing mechanisms, the investigation of their actual contributions can provide relevant insights on this issue”. A number of recent studies (Carcello et al., 2005; Arena and Azzone, 2007; Coram et al., 2008) have directly called for further research to examine how IAF effectiveness is defined and assessed. This study responds to these calls and investigates IAF performance evaluation practices by addressing the following research question:

**RQ3: How is the effectiveness of the IAF evaluated?**
3. RESEARCH METHOD

Evidence was collected through semi-structured interviews with six Audit Committee Chairs (ACCs) and six Chief Audit Executives (CAEs). The choice of the participants and the sample size is similar to other recent interview studies investigating the IAF (Sarens and De Beelde, 2006; Mat Zain and Subramaniam, 2007; Sarens et al., 2009). ACCs and CAEs were chosen as the most appropriate participants as they are considered to be in the best position to provide insights into the research questions outlined in section 2. Under current regulatory and best practice guidelines, the AC/ACC is the key internal corporate governance stakeholder with primary responsibility for the oversight of the IAF, and with whom the IAF has a direct relationship in terms of functional reporting lines.

The primary aim of employing semi-structured interviews is to gain in-depth insight into the perceptions of the individual interviewees and to develop a greater understanding of corporate governance processes (Gendron et al., 2004; Gendron and Bédard, 2006; Turley and Zaman, 2007; Beasley et al., 2009; Cohen et al., 2009, 2010; Gendron, 2009), rather than to draw generalisations from the study. According to recent research on the use of purposive samples in qualitative inquiry, sample size should be determined by the concept of data saturation, which is the point at which data gathered in subsequent interviews no longer produces new thematic insights (Guest et al., 2006). Guest et al. (2006) report that saturation is generally reached after 12 interviews, and that major themes are present after six interviews. In the present study, we found that all key themes were present in the initial three interviews and recurred in each of the subsequent interviews.

4 The term Chief Audit Executive refers to the individual in charge of the internal audit function within an organisation and may be referred to by other terms, such as the Chief Internal Auditor, Head of Internal Audit, Chief Audit Officer or Director of Audit. The ISPPIA defines CAE as: “The top position within the organisation responsible for internal audit activities. Normally, this would be the internal audit director... The term also includes such titles as general auditor, chief internal auditor, and inspector general.”
3.1 THE PARTICIPANTS

Participants\textsuperscript{5} were recruited from organisations across a range of industries as prior research indicates the need to consider the industry context in examining governance mechanisms (Beasley \textit{et al.}, 2000). Table 1 provides a profile of the participants and their organisations. Each participant and their organisation has been identified by a code in order to ensure anonymity in view of the confidential and sensitive nature of the information collected.

\begin{table}
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Participant} & \textbf{Industry} & \textbf{Size (Total Assets)} \\
\hline
Participant 1 & Finance & $2.5 billion \\
Participant 2 & Manufacturing & $3.0 billion \\
Participant 3 & Retail & $1.5 billion \\
Participant 4 & Technology & $4.0 billion \\
Participant 5 & Mining & $5.0 billion \\
Participant 6 & Energy & $6.0 billion \\
Participant 7 & Healthcare & $3.5 billion \\
\hline
\end{tabular}
\caption{Participant Profiles}
\end{table}

\[\text{Insert Table 1 about here}\]

Seven respondent organisations participated in this study. Six of the organisations were in the top 150 ASX listed companies (average total assets of $6.9 billion), while one was a public sector entity (ORG5). Given the large size ($26 billion total assets) and nature of ORG5, as well as the mandatory requirement to have an AC in public sector entities\textsuperscript{6}, it was considered that the organisation operates within a similar context to that of the top ASX 150 listed companies, and was hence included in the sample. Taking into consideration the number of boards each ACC sat on in the capacity of a director at the time of the interviews, the sample of organisations from which the ACCs drew their experience and comments increases to 15. The average experience of ACCs, as a director in the target organisation, was 9.5 years (range two to 13 years). For the IAFs, the length of in-house presence for those functions which were fully in-house or co-sourced averaged four years. Respondent CAEs had an average of ten years’ experience in internal auditing.

\textsuperscript{5} Majority of the participants were recruited via email approach by the Institute of Internal Auditors – Australia on behalf of the researchers. Two ACCs were recruited with the assistance of a Big-4 partner.

\textsuperscript{6} Section 46 of the \textit{Financial Management and Accountability Act 1997} provides that “a Chief Executive must establish and maintain an Audit Committee within the entity, with the functions and responsibilities required by the Finance Minister’s Orders”.

3.2 Data

Data were collected through semi-structured interviews, which were informed by the literature review and discussion with academic colleagues and senior representatives of the Institute of Internal Auditors – Australia\(^7\). The questions were designed to be as open-ended as possible so as to allow participants to articulate their responses without explicit boundaries and without imposing preconceived categorisations that inhibit responses (Fontana and Frey, 2005). A non-directional style of questioning was employed in order to mitigate interviewer bias. Participants were asked if they had any further relevant areas of interest they would like to pursue after all issues were discussed.

A protocol was developed for recording and analysing the data from the interviews. This process was undertaken to mitigate the primary disadvantage of in-depth interviews, that is, the inherent complexity in analysing free responses (O’Dwyer, 2004). All interviews were attended by two researchers who simultaneously took notes and subsequently collaborated on combining their individual written responses. The combined responses were then categorised according to target issues. Digital audio recordings were used to clarify any contentious matters.

In order to validate the data collected, the combined interview summary, categorised by target issues, was emailed to each interviewee for approval. This allowed each interviewee to refine, clarify or add any relevant details. The final interview responses were then summarised individually, and within and across ACC and CAE categories. This facilitated the identification of themes by category by which the collected data was analysed.

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\(^7\) Interviews were conducted between August 2008 and January 2009.
4. RESULTS

4.1 THE INTERNAL AUDIT FUNCTION AND ITS ROLES

Research Question 1 (RQ1) investigates the roles and responsibilities of the IAF in current practice and how these have changed over recent years.

All CAEs and ACCs interviewed perceived the development and performance of the annual IAF work plan to be a significant area of responsibility. CAEs are typically given the responsibility for developing the work plan with input from the AC and in consultation with other stakeholders, including senior management and the external auditor. CAEs reported that the annual work plan focuses on the examination of a limited number of issues, primarily selected on the basis of risk prioritisation.

Limited references were made in the interviews to the IAF’s role in the financial statement audit or purely financial auditing. In elaborating on items contained within the audit plan, participants across all organisations heavily emphasised the IAF’s role in compliance and particularly operational audits based on risk. All CAE participants reported that they have full and free access to all areas within the organisation to perform activities including testing of internal controls, compliance work (generally regulatory e.g. ASX CGC Guidelines, occupational health and safety requirements) and evaluating risk management processes. CAE2 noted that the IAF’s work revolves around IT and business aspects incorporating operational and compliance issues with a trend towards risk management activities.

Another primary responsibility reported by all ACCs was the IAF’s role in supporting the AC in its duties. A key part of this role is the provision of an independent assessment of risk management and risk processes within the organisation. ACCs reported that they place substantial reliance on the IAF in order to be able to perform their duties. As ACC6 explained
The IAF is very important to the AC. The AC by itself cannot do much given that it meets infrequently, six times a year for two to three hours, working out to 18 hours annually. The AC needs some leverage which is provided by the IAF.

In examining its role in the risk management process, it is pertinent to note that the IAF is typically not responsible for the risk identification process (referred to as developing the “risk register” by several participants). This process is left to management in four of the participating organisations. ORG3 outsources the risk identification process to a Big-4 firm (not the same firm as the external auditor) given its one-person IAF and absence of a risk function in the organisation. On the other hand, in ORG7, this process is jointly undertaken by the CAE and the organisation’s risk team. Both ACCs and CAEs perceived the primary responsibility in relation to risk processes to be the provision of an independent opinion on risk identification and the risk management framework. CAE5 stated:

It is not the role of the IAF to identify risk but we will identify risks during the course of audits as they come up... Risk identification is a vibrant process, particularly in the current volatile business environment.

It became evident during the interviews that there was a difference in the respondents’ emphasis on aspects of the IAF’s roles. CAEs emphasised consulting (or business aligned) aspects, while ACCs emphasised assurance related aspects. This has latent implications for the independence of the IAF (and hence the quality/objectivity of the assurance provided to the AC) given the potential for conflict between these two aspects of the IAF’s role. This divergence in emphasis would also have implications for the IAF’s performance evaluation, and should be taken into consideration in the process.
It is worth noting that while none of the CAEs interviewed spoke of the IAF having responsibility in relation to the whistleblower system, two of the ACCs (ORG1 and ORG3) considered the IAF to be the ideal conduit for administering the system as “it is critical for a whistleblower to have access to someone outside of management” (ACC3). While this issue was not examined specifically by the present study, it highlights a potential area for future research as, for example, the Sarbanes-Oxley Act in the U.S. bestows responsibility for designing and implementing a whistleblower system on the AC. Although no such mandatory requirement exists in Australia, it has been suggested that the IAF may be instrumental in assisting the AC in this regard (Moeller, 2009).

Overall, CAEs were satisfied with the current roles of their IAFs, but given the opportunity, they would like to increase the scope of the IAF to include greater coverage including macro-risk issues such as emerging risk and strategic risk. However, this is not unanimous as CAE5 maintained that the “IAF should not be engaged in strategy or telling management how to do their job”. There is also awareness of various limitations in the IAF’s ability to increase its scope in view of limited resources, as pointed out by CAE1, “I would like to double our budget and go twice as fast but the organisation may not be able to digest that amount of change, so the scale is probably right”.

ACCs and CAEs perceived similar changes to the role of the IAF over the last three to six years. Both respondent groups indicated that the IAF now has a greater role in risk issues. CAE2 explained that the IAF has moved to more risk-based auditing (particularly around operational risks), and less traditional ‘tick and flick’ financial audits. This is echoed by ACC1 who suggested that “the IAF has assumed the risk function within the organisation and is expanding”. Similarly, ACC2 put forth that internal auditors are now “talking business talk” and are taking a pro-active role in risk management. ACC5 noted that there has been a “transition in the role of the IAF as just an assurance process to adding value in terms of
improvements to business systems and efficiencies”. This is consistent with Sarens and De Beelde’s (2006) suggestion of a likely return to a business focus in the IAF’s consulting activity following a short term shift to a focus on financial controls as a result of the introduction of the Sarbanes-Oxley Act.

Respondents generally attributed the changing nature of the roles of the IAF to recent regulatory reforms (both locally and internationally) as well as overall cultural shifts within their organisations that have seen increased acceptance of the importance and value of having an IAF. The cultural shifts have been driven largely from the top of the organisation given the increased emphasis on corporate governance and greater sensitivity to the individual liabilities of directors including those on the AC. CAE5 suggested that this is due to greater education at the board level, and that “people have seen the benefits of having the IAF as the ‘eyes and ears’ of the organisation”, and “where IAF reports were taken as read before, there is now a lot more engagement”. According to CAE1 the introduction of the ASX CGC Guidelines in 2003 increased the focus on risk management, and the IAF is often in the best position to give management advice and to provide assurance in this area. In addition, CAE5 perceived increased directors’ liability and personal exposure as significant drivers of the changes and pointed to “The Daily Telegraph phenomena”, in which stories of failed internal controls (e.g. HIH, Lehman Brothers) appear on the front pages of the mainstream media. This is consistent with similar findings in recent studies (Sarens and De Beelde, 2006; Cohen et al., 2010). Three of the respondent organisations had also switched to in-house functions in the last three to six years which was perceived as contributing to increased visibility and status of the IAF within the organisation.

Lastly, when asked to comment on their future expectations relating to changes in the role of the IAF, both ACCs and CAEs indicated that they expect the IAF’s role to develop an even greater focus on risk issues in the future with a move towards “just-in-time or real-time
Several respondents also indicated a role for the IAF in business improvement processes and efficiencies within the organisation, particularly given its privileged position and wide access within the organisation. As CAE1 explained, the IAF “looks at how each business unit identifies and manages the baseline and process level risk, and ensures adequacy of key processes, driving efficiency and effectiveness gains and making sure they are maintained”. ACC1 and ACC5 also indicated that in the future, they would expect the IAF to add value and contribute to business performance through business improvement initiatives and identification of financial opportunities for the business.

In summary, the results are consistent with those of Castanheira et al. (2010), who find that there is a trend towards a greater focus on risk-based auditing including operational and business risks by the IAF. The results also support prior research that reports a greater emphasis placed on business and operational risk areas by the IAF (Paape et al., 2003; Ernst & Young, 2007). The results also provide a context for the somewhat contradictory results of KPMG’s (2006) survey in which fewer than half (42%) of the respondents were ‘very satisfied’ that the IAF plan is linked to the agreed risk profile for the company. The findings from the present study are that the IAF is not responsible for risk identification or risk profiling, with unanimous agreement that this is management’s responsibility. Rather, the IAF’s role is to provide an independent review of risk processes and ensure that risk mitigating controls are in place.

### 4.2 Effectiveness of the Internal Audit Function

Research Question 2 (RQ2) investigates the key factors perceived to contribute to IAF effectiveness. The factors identified by the participants as instrumental in contributing to perceptions of effectiveness in this section relate to the structure, status, and relationships of the IAF, along with human resources, in terms of staffing and competencies.
4.2.1 In-house versus Outsourced Internal Audit Function

As discussed under Section 4.1 above, a shift to in-house functions for three of the seven organisations contributed to positive perceptions of the IAF’s effectiveness, which is likely the result of increased visibility and profile. This supports the suggestion by Coram et al. (2008) that a full or partial in-house IAF is more effective than one that is completely outsourced. All ACCs interviewed would ideally choose an in-house IAF because of its intimate knowledge of the organisation. As ACC3 stated

I came to the view at some stage that the external people really did not know what was going on, that you really had to have somebody there to know what was going on and who was covering up and where things really could be improved.

However, respondents also pointed out that the economics of having an in-house IAF have to be considered. ACC4 and ACC5 suggested that, although an in-house IAF works best, it is limited by the size of the organisation. ACC4 explained that “a large organisation would have the critical mass in the team to get the range of expertise necessary, but it would make more sense for a small company who needs access to expertise to outsource the IAF”.

In the organisations where a co-sourced arrangement for the IAF was in place, participants perceived that such an arrangement allowed the IAF to achieve effectiveness in its performance through having access to a wide range of expertise and geographic reach that was not possible through the use of a purely in-house function. It is significant that ACCs considered it important to have a central point of contact and accountability within the organisation (the CAE) when such an arrangement was in place.
4.2.2 Staffing and Competencies

Characteristics relating to the human resources of the IAF were brought up consistently by both ACCs and CAEs as reflected by CAE4’s view that “there is now good talent in the audit and risk space”. There was clear recognition that the IAF needs to be staffed with a wide range of skills including finance, audit, operational (business), technological, and occasionally legal competencies. ACC6 also pointed out that it is also important to have a team (i.e. a number of IAF staff) of like-minded individuals “who can use one another as a sounding board for issues and concerns” given his awareness that “being in the IAF is a challenging role and can be isolating”. CAEs likewise reported the importance of the necessary skills including accounting and IT backgrounds.

Respondents also drew attention to the importance of the CAE’s characteristics. ACCs noted heightened expectations of the CAE and the quality of the person in the role. They emphasised that a good CAE is able to work with other stakeholders in the organisation and is not afraid to voice his or her opinion even in controversial situations. As ACC3 stated, it is necessary to have a “good CAE who is able to command the confidence and respect of the people out in the field so as to be able to gain access and cooperation”. Attention was also drawn to the fact that the role of the CAE can be an isolated one and that the support of the AC is necessary in this regard. As some of the respondent CAEs have been in their position for a number of years, issues were raised about whether there was a need to have a limited tenure and a rotation of the CAE, as well as more certainty in the career path of a CAE.

In summary, the results of the study highlight the emphasis placed on having the right people with the appropriate skills (particularly accounting and IT) in the IAF and especially in the role of the CAE. This supports the findings from Ernst & Young (2007, p. 2) that
“people are still the foremost challenge” for IAFs. Further, the results confirm the findings of prior studies that perceptions of IAF effectiveness are related to the level of expertise within the function (Mat Zain et al., 2006) and the support, status and position of the IAF (Leung et al., 2004; Mat Zain and Subramaniam, 2007). It is also worth noting that the issue of the career path of the CAE came up in several interviews and may be an area for future research.

4.2.3 Relationships with Stakeholders, Organisational Status and Support

The relationships of the IAF, particularly with the AC and senior management, in terms of support and appropriate reporting lines are perceived to be crucial in contributing to IAF effectiveness by ensuring independence and objectivity.

IAFs across respondent organisations, with the exception of CAE2, report directly to the AC/ACC, with administrative reporting to senior executives including the CFO or the Chief Risk Officer. CAE2 reports directly to both the CEO and ACC for all functional matters. CAE1 noted that as a result of the introduction of the ASX CGC Guidelines (2003), the reporting line for the IAF to the AC (as opposed to the CFO) had become much clearer. He also added that “the CFO would be tempted to use the IAF as a free resource to save costs” (particularly given the regulatory requirements for the CFO to sign off on the financial statements) if the IAF was to report directly to the CFO. CAEs considered the AC critical to the protection of their independence and objectivity by ensuring their job security. CAE2 stated that “in all reality [we] would not be able to perform the function properly” without AC support.

Both ACCs and CAEs perceived that it is necessary for the AC to elevate and protect the status and visibility of the IAF within the organisation by providing the appropriate platform for the IAF to present findings at AC meetings. This sends the signal that the IAF is an important function within the organisation and its work is not meant to be taken lightly.
Further, the AC empowers the IAF and is used “as a hammer to chase management on outstanding issues if necessary” (CAE2). CAEs considered that the AC reviewing and approving the IAF work plan, scope and budget, provides support to the IAF and “gives credence to the IAF reports” (CAE2). ACs also ensure that the IAF is adequately resourced, including approving the use of external resources as necessary, which “sends the signal that the IAF is well supported” (ACC3).

Apart from providing a forum for the IAF to be heard, ACCs also indicated that they consider the AC’s support of the CAE, particularly in potentially controversial situations, necessary in contributing to the function’s effectiveness. This sentiment is echoed by CAEs as “it is a very rocky road in a situation when they [ACs] do not; it is a very uncomfortable and potentially untenable place to be” (CAE1). CAE4 suggested that the best ACC provides “questioning support” by mentoring the IAF and speaking to the CEO on its behalf. CAEs also believed that it is necessary for the AC to continue to raise the profile of the IAF within the organisation, such as by “ensuring that the CAE is present in operations meetings” (CAE3).

Personal support from the AC (and particularly ACC) for the CAE is also perceived as a key factor contributing to IAF effectiveness. CAEs perceived their role to be autonomous and often isolated. CAE1 noted that he did not know “if all AC members realise the importance of their support, but that the loyalty and relationship between the ACC and the CAE are vitally important”. He suggested that it is the knowledge that the ACC is relying on him that motivates him and provides a great sense of responsibility and accountability in that he is “looking out for him [ACC] personally”. ACCs typically noted that their significant influence in hiring and firing decisions is critical to providing job security for CAEs. Lastly, it is noteworthy that CAE2 mentioned that he would appreciate “AC members imparting more of their knowledge and experience, particularly since they sit on the boards of other
companies and interact with other CAEs and IAFs”. He suggested that this would allow the CAE to benchmark the performance and effectiveness of the IAF.

Overall, the results indicate that the relationship between the AC and the IAF (and ACC and CAE) is viewed as critical to IAF effectiveness. The findings provide an insight into the nature of the support and interactions between the AC and the IAF and are generally consistent with post-regulatory reform studies in the U.S. (Beasley et al., 2009; Cohen et al., 2009). The results also provide support for the importance of establishing explicit reporting lines for the CAE (Mat Zain and Subramaniam, 2007), and the finding that a majority of CAEs report directly to either the AC alone, or to both the CEO and the AC (Leung et al., 2004). The present study also provides context and depth for considering Cohen and Sayag’s (2010) report that top management support is the most crucial to the operation and success of the IAF, in showing how the AC is a crucial link in this process.

4.3 Evaluating the Internal Audit Function

Research Question 3 (RQ3) examined the performance evaluation practices of the IAF. While this varies across organisations, the AC or ACC typically has input in the process, and is generally responsible for determining the CAE’s salary and bonus. CAEs self-report the performance of the IAF in relation to internally and externally developed guidelines, particularly from the ISPPIA.

The most commonly employed measures of effectiveness relate to the efficiency of the IAF with regard to the annual IAF work plan, in terms of completion of planned audits and timely completion of the work plan, as well as measures of acceptance and adoption of IAF recommendations. It is noteworthy that value-tracking in terms of cost savings or value creation as an IAF performance metric was only raised by CAE1, although ACC1 and ACC5 indicated that it is likely to become an important criterion. ACC2 recounted that a key
consideration, particularly in the initial years of establishing an in-house IAF, was a cost-benefit analysis of the value added by the IAF. Table 2 presents the performance metrics for the IAF employed by two of the participant organisations which have the most comprehensive IAF performance evaluation frameworks.

| Insert Table 2 about here |

There are a range of practices relating to the performance evaluation of the IAF, and diversity in the operationalisation of performance metrics. The results of the present study provide support for Ernst & Young’s (2007) survey findings that one of the top metrics used in the measurement of IAF effectiveness is the completion of audits in comparison to the IAF plan, and that a majority of IAFs do not perform any value-tracking. CAE5 cautioned that participation in business improvement initiatives or employing “dollar based KPIs” may impair the independence and objectivity of the IAF, and hence IAF evaluation has to be very careful in engaging in these areas.

The complexity in performing performance evaluations of the IAF was well explained by CAE6 (external service provider), who has extensive experience with several organisations implementing such processes. He suggested that performance evaluation needs to be “aligned with objectives… [and] balanced, but it is difficult to judge quality and qualitative information as opposed to quantitative information. For example, whether the IAF delivered on budget does not tell you anything”.

Table 2 also illustrates the emphasis on quantitative measures (e.g. coverage, timely completion) in evaluating the performance of the IAF. The participants’ responses indicate that many of the currently used metrics are not necessarily reflective of the performance or effectiveness of the IAF.
4.4 Additional Analyses

In order to provide a more holistic understanding of the IAF, respondents were asked to comment on the role of the external auditor, as a key external stakeholder. Respondents indicated on the whole that there was a good relationship between the two parties, with varying levels of mutual reliance between the IAF and the external auditor. External auditors typically had free access to the IAF’s reports and working papers. There was consultation between both parties, as necessary, and work was coordinated in order to avoid duplication ("not replicating the wheel in undertaking the exact same project"), and to promote cost efficiency in some instances (ACC5), and/or to ensure smooth business operations and minimal disruptions in others (CAE1, CAE4). Our results complement Cohen et al.’s (2010) findings that external auditors perceive greater coordination with the IAF, increased stature, reliability and independence of the IAF as well as the importance of its role in assisting the AC.

While ACCs placed reliance on the work of the external auditors, they tended to rely more on the IAF for assurance and comfort as the IAF is ‘internal’. Tensions in the relationship with the external auditor in relation to issues with the audit fees were reported. As ACC3 pointed out, “auditors these days never believe that their fee is sufficient”, and there are always things that occur which require the external auditor to do additional work for an additional fee. ACC4 similarly noted that “the external auditor running over budget creates natural pressures” and that tensions occasionally arise in the planning process as the “external auditor or IAF want to do their own thing and push themselves apart or push issues to each other”. In summary, while there is an overall cordial relationship between the external auditor and IAF, “it could be better” (CAE4), as there is value to be had in improving the dialogue between these key corporate governance mechanisms (ACC4).
5. CONCLUSION

The paper aims to provide insights into the roles and responsibilities of the IAF as well as the characterisation of its effectiveness and performance evaluation practices. We find that that the IAF has experienced an expansion and refocus of its role within the corporate governance mosaic. This is generally attributed to recent regulatory changes, increased awareness of the value of a quality IAF, overall cultural shifts, as well as the increased quality of the individuals in the key roles within both the IAF and the AC. We also report diversity in the practice of evaluating the effectiveness of the IAF. The findings suggest that performance evaluation mechanisms of the IAF have not evolved contemporaneously with its roles. The misalignment between its roles and evaluation gives rise to difficulty in assessing the extent to which the IAF is meeting stakeholders’ expectations.

The findings of the present study should be considered in light of a number of limitations. The first limitation is inherent in the use of a qualitative approach to collecting data, in that the findings are limited in terms of their generalisability. The data collected represents the perceptions of the individual respondents and are not necessarily representative or generalisable to the wider population of ACCs and CAEs. However, given that the aim of the present study is to provide depth to prior questionnaire based survey research, the use of semi-structured interviews was considered appropriate in meeting this aim. The generalisability of the study is also limited in view of the potential sample selection bias. Respondents were recruited on a voluntary basis, and this may skew the results in favour of organisations in which the ACs and/or IAFs represent (or perceive themselves to represent) better practice than the wider population. Further, our data are limited to the perceptions of ACCs and CAEs, and are not as comprehensive as they would have otherwise been if we had included other stakeholders, such as management and external auditors.
This study investigated the perceptions of ACCs and CAEs in the context of mandatory regulatory AC requirements relating to the composition and responsibilities as set out in the ASX CGC Guidelines (with the exception of ORG5), and a voluntary basis for IAF establishment (except ORG 5). Future research may consider investigating similar issues in other regulatory contexts and national settings. For example, studies may focus on different types of organisations, such as those in the public sector, where there are a different set of regulations and requirements. Future research may also investigate some of the issues in more depth, for example, the development of more appropriate performance evaluation of the IAF in view of its increasing involvement in operational and value-added activities and whether this shift has a potential impact on the IAF’s objectivity. Future studies might also examine the perceptions of other actors in the corporate governance mosaic, including senior management such as the CFO and CEO, as well as the external auditors. Lastly, the CAE’s career path (and need for limited tenure or rotation) is another area worthy of further research.
REFERENCES


Australian Institute of Company Directors (AICD), Auditing and Assurance Standards Board (AUASB) and Institute of Internal Auditors - Australia (IIA) (2008), Audit committees: A guide to good practice, Australian Institute of Company Directors, Sydney.


## Appendix 1: IAF’s roles and responsibilities

<table>
<thead>
<tr>
<th><strong>KEY ROLES/RESPONSIBILITIES REPORTED IN THIS STUDY</strong></th>
<th><strong>FINDINGS OF THE CURRENT STUDY</strong></th>
<th><strong>PRIOR FINDINGS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Development and performance of annual IAF work plan including testing of internal controls and compliance work.</td>
<td>A significant amount of effort goes into this process. It is increasingly becoming a dynamic risk-based process so as to facilitate continuous auditing processes in the current business environment.</td>
<td>The results are in line with the extant academic and professional literature on the IAF. Given the increasing regulatory requirements, there is significant increase in compliance work, e.g. ASX Corporate Governance Council’s Guidelines Principle 7 and the Sarbanes-Oxley Act in the U.S.</td>
</tr>
<tr>
<td>Independent assessment of risk management processes which includes the identification of risk</td>
<td>The IAF is not responsible for the risk identification process which is generally left to management. The IAF is responsible for passing an independent opinion on the completeness and accuracy of the identification and response to the risks identified. The IAF is also instrumental in driving change processes in some instances where there is significant room for improvement identified.</td>
<td>Prior survey research has reported that ACs have concerns that they are not receiving updated risk profiles from the IAF. The present study provides the rationale for this finding. Prior studies have also examined the changing nature of the IAF’s role in risk management and find that the IAF is playing an increasingly active role in this area, with varying levels of responsibility across different jurisdictions.</td>
</tr>
<tr>
<td>Business improvement processes</td>
<td>This is an increasingly important area of the IAF’s work and likely to increase in prominence in the future. It is used as leverage to demonstrate the relevance and contribution of the IAF.</td>
<td>Prior studies have reported decreased IAF activity in business improvement processes and increased focus on internal controls over financial reporting in the post Sarbanes-Oxley era. Prior studies have also noted potential for the IAF’s consulting role to impair its independence and objectivity.</td>
</tr>
<tr>
<td>Administering the whistleblower system</td>
<td>There is a view (and preference) in some organisations that the IAF be the conduit for/administer the whistleblower system.</td>
<td>The Sarbanes-Oxley Act in the U.S. has endowed upon the AC responsibility to implement a whistleblower system for the organisation. This suggestion is also made in the professional literature/guidance although it remains to be examined in practice.</td>
</tr>
</tbody>
</table>
# TABLE 1
Participant Information

<table>
<thead>
<tr>
<th>ACC &amp; AC demographics</th>
<th>ACC1</th>
<th>ACC2</th>
<th>ACC3</th>
<th>ACC4</th>
<th>ACC5</th>
<th>ACC6</th>
<th>ORG7 AC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial expertise of ACC</td>
<td>Undisclosed</td>
<td>FCA, FAICD</td>
<td>FCPA</td>
<td>FCPA, MAICD</td>
<td>None</td>
<td>FCA, FCIS, MACS</td>
<td>FCPA, FAICD, FAIM</td>
</tr>
<tr>
<td>No. of financial experts in AC (including ACC)</td>
<td>Undisclosed</td>
<td>1 (25%)</td>
<td>3 (100%)</td>
<td>2 (67%)</td>
<td>Undisclosed</td>
<td>1 (33%)</td>
<td>3 (75%)</td>
</tr>
<tr>
<td>Independent AC members</td>
<td>4 (80%)</td>
<td>4 (100%)</td>
<td>2 (67%)</td>
<td>3 (100%)</td>
<td>n/a</td>
<td>3 (100%)</td>
<td>4 (100%)</td>
</tr>
<tr>
<td>AC meetings in a year</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>7</td>
<td>4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CAE &amp; IAF demographics</th>
<th>CAE1</th>
<th>CAE2</th>
<th>CAE3</th>
<th>CAE4</th>
<th>CAE5</th>
<th>ORG 6 IAF</th>
<th>CAE6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional qualification</td>
<td>FCA, CIA, BBus</td>
<td>CISA, BComm</td>
<td>CPA, BBus &amp; IT</td>
<td>BBus, MBA</td>
<td>CA</td>
<td>Unknown</td>
<td>BComm</td>
</tr>
<tr>
<td>Professional experience of CAE</td>
<td>Big-4 Senior Manager</td>
<td>Big-4 IT auditor</td>
<td>Financial controller</td>
<td>Big-4, Senior IA manager</td>
<td>Big 4 partner, IAF specialist provider</td>
<td>Unknown</td>
<td>Acct &amp; finance manager</td>
</tr>
<tr>
<td>IAF staff (incl. CAE)</td>
<td>6 (in-house)</td>
<td>5 (in-house)</td>
<td>1 (co-sourced)</td>
<td>3 (co-sourced)</td>
<td>Outsourced</td>
<td>12 (co-sourced)</td>
<td>4 (co-sourced)</td>
</tr>
<tr>
<td>Organisation profiles</td>
<td>ORG1</td>
<td>ORG2</td>
<td>ORG3</td>
<td>ORG4</td>
<td>ORG5</td>
<td>ORG6*</td>
<td>ORG7*</td>
</tr>
<tr>
<td>GICS Industry Group*</td>
<td>Media</td>
<td>Diversified Financials</td>
<td>Media</td>
<td>Materials</td>
<td>Diversified Financials*</td>
<td>Real estate</td>
<td>Food Beverage &amp; Tobacco</td>
</tr>
</tbody>
</table>

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* ACC6/CAE6 are not matched pairs as it was not possible to conduct interviews with the corresponding ACC/CAE. The participant/organisation relations are as follow: ACC6:ORG6; CAE6:ORG7.

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* ORG5 is a federal entity that would be classified under the Diversified Financials Industry Group if it were a public company.
TABLE 2
Performance Operationalisation and Measurement of the Internal Audit Function

<table>
<thead>
<tr>
<th>ORG1</th>
<th>ORG3</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Attributes (4 top line, 1 underlying):</td>
<td>5 KPIs:</td>
</tr>
<tr>
<td>- assurance (covering key areas within the year)</td>
<td>- timely completion of IAF plan</td>
</tr>
<tr>
<td>- shareholder value (value preservation and creation through identifying efficiency opportunities)</td>
<td>- identify and address risk in proactive manner</td>
</tr>
<tr>
<td>- strengthening control environment</td>
<td>- manager acceptance of IAF recommendations</td>
</tr>
<tr>
<td>- stronger management team</td>
<td>- increase effectiveness of ICs</td>
</tr>
<tr>
<td>- efficiency of IAF (budget and scope)</td>
<td>- increase profile of IAF</td>
</tr>
</tbody>
</table>