

Does Internal Audit Function Quality Deter Management Misconduct?

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Dissertation – Executive Summary

This study examines the relation between internal audit function quality as defined by standard setters (e.g., American Institute of Certified Public Accountants [AICPA], The Institute of Internal Auditors [IIA], and Public Company Accounting Oversight Board [PCAOB]) and the likelihood of management misconduct, such as financial reporting fraud, bribery, and misleading disclosure practices. Standard setters such as the AICPA, Committee of Sponsoring Organizations of the Treadway Commission (COSO), and The IIA posit that internal audit functions serve as a key resource to audit committees for monitoring senior management, and high-quality internal audit functions deter management misconduct. However, for all industries except the banking industry, U.S. regulators do not enforce internal audit function quality or require disclosures relating to internal audit function quality. This treatment is in stark contrast to the regulatory requirements placed on other corporate monitors of management, such as boards of directors, audit committees, and external auditors.

In response to major accounting scandals such as Enron and WorldCom, regulators placed additional requirements on boards of directors, audit committees, and external auditors to improve the quality of each with respect to monitoring management. However, regulators did not pass requirements that directly improved internal audit function quality. Recently, NASDAQ proposed requiring listed firms to have an internal audit function that is overseen by the audit committee. This study informs standard setters, regulators, audit committees, and shareholders

about whether internal audit function quality deters management misconduct incrementally to other monitors.

Using proprietary survey data from The IIA, I created a composite measure of internal audit function quality that captures experience, certification, training, use as a management training ground, reporting relationship with the audit committee, and size. I also employed a factor analysis to create measures of competence and objectivity—two components of internal audit function quality recognized by standard setters. I then tested to what extent internal audit function quality, competence, and objectivity are associated with observable instances of management misconduct, defined as credible allegations of intentional illegal acts by executive management, such as fraud and bribery. These data came from (1) U.S. Securities and Exchange Commission (SEC) or U.S. Department of Justice enforcement actions claiming fraud, intentional misconduct, or violations of the bribery provision of the Foreign Corrupt Practices Act of 1977 and (2) settled securities class action lawsuits.

Based upon a final sample of 1,398 firm-years representing 617 unique firms from 2000 through 2009, the analysis reveals a negative relation between internal audit function quality and management misconduct, even after controlling for other determinants of misconduct, including board of director, audit committee, and external auditor quality. This suggests that, on average, firms with higher quality internal audit functions had fewer instances of management misconduct. This effect is economically significant, as a firm with internal audit function quality one standard deviation above the mean is approximately 2.3 percentage points less likely to have management misconduct than a firm with average internal audit function quality. This is approximately 24 percent of the 9.9 percent unconditional probability of management misconduct. Analysis of the individual factors comprising internal audit function quality revealed

that internal audit function competence, but not objectivity, is negatively related to the likelihood of management misconduct, suggesting that internal audit function competence is at least as important as objectivity in deterring management misconduct.

In addition to the data analysis described above, the project also included analysis of how firms respond to revealed misconduct. If participants in the governance process believe internal audit function quality deters management misconduct, then firms that have experienced executive misconduct should increase internal audit function quality in response to revealed misconduct. A difference-in-differences approach revealed that firms that experienced misconduct had low internal audit function quality and internal audit function competence during misconduct years as compared to a matched sample of firms. Then, in post-misconduct years, misconduct firms increased internal audit function quality through internal audit function competence. This increase in competence was due to hiring more experienced and certified internal auditors. However, changes in internal audit function objectivity for misconduct firms after misconduct revelation were not statistically different from the changes in internal audit function objectivity for the matched sample. The increased hiring of experienced and certified internal auditors after misconduct years is consistent with the proposition from standard setters that internal audit functions serve as a key resource for audit committees in monitoring management.

This study contributes to the internal audit function literature by providing empirical evidence consistent with the proposition that internal audit function quality and competence deter management misconduct. This study also contributes to the governance literature that studies firm governance changes in response to management misconduct. From a policy perspective, the findings of this study inform the debate relating to the recently released NASDAQ proposal that

would require listed firms to have an internal audit function and for the audit committee to take sole responsibility for the internal audit function. These new requirements directly address internal audit function objectivity. The results of this study suggest that internal audit function competence should also be considered as part of the NASDAQ proposal.