

The Effects of Internal Audit Management Training Ground and Reporting Relationships
on Internal Auditors' Judgments

by

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Abstract

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This study examined whether management training ground (MTG) internal auditors or career internal auditors who report to either the audit committee chair (ACC) or the chief financial officer (CFO) make more conservative (higher audit quality) judgments in performing fraud and control risk assessments. MTG internal auditors are hired or transferred into the internal audit department to work for relatively short periods for management training purposes. The policy is designed to promote them into management positions outside the internal audit function (IAF). In contrast, career internal auditors typically remain and advance their career within the IAF. Based primarily on accountability and agency theories as well as an acceptability heuristic process, I hypothesized that career internal auditors would make more conservative judgments than MTG internal auditors, and that career internal auditors who report to the ACC would make more conservative judgments than career internal auditors who report to the CFO. In a 2 x 2 between-subject experiment with experienced internal auditors as participants, I find that, contrary to prediction, internal audit (IA) type (MTG internal auditors or career internal auditors) offers comparable judgments, indicating that the IA type or the interaction of IA type with the reporting relationship type (ACC or CFO) did not reveal any significant judgment conservatism. These results remain unchanged after adding various control variables to the model. The findings have implications for academic research, practitioners, and policymakers.

Executive Summary

This study examined whether management training ground (MTG) internal auditors or career internal auditors who report to either the audit committee chair (ACC) or the chief financial officer (CFO) make more conservative (higher audit quality) judgments in performing fraud and control risk assessments. The Internal Audit Foundation has articulated the significance of internal auditors' reporting relationships. Academic and practice literature reveals that even when the internal audit function (IAF) is still in its developing stage, the IAF makes significant contributions to organizations in improving governance, internal control, financial reporting, fraud risk assessment and detection, safeguarding of assets, etc. The IAF is a critical element of good corporate governance. Prior research on the use of IAF as a MTG provided conflicting outcomes, mostly negative consequences. The Sarbanes-Oxley Act of 2002 requires corporations to take various measures to improve accountability and internal controls and, therefore, place responsibility for the internal controls on management. The Public Company Accounting Oversight Board (PCAOB) supports external auditors (EAs) depending on the IAF when the internal audit activities satisfy specific criteria. Besides, The IIA recommends articulating internal audit effectiveness. This study examined the interaction that involves the CFO, ACC, and internal auditors at a micro level.

This study used an experimental (survey) design, a 2 x 2 between-subject experiment with experienced internal auditors as participants. The experimental case materials were developed after conducting a comprehensive review of accounting literature on the topics of IAF with a focus on the internal audit type and internal audit reporting relationship. Additionally, I reviewed relevant best practices and guidance from the IIA, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the U.S. Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), benchmark reports, and public

companies' financial data in the manufacturing industry. The survey was conducted in two countries, in the U.S. and India (approximately 11,000 members), helping to have a diverse group of participants.

The results reveal that internal audit (IA) type (MTG internal auditors or career internal auditors) offers comparable judgments, indicating that the IA type or the interaction of IA type with the reporting relationship type (ACC or CFO) did not reveal any significant judgment conservatism. These results remain unchanged after adding various control variables to the model. Unlike recent literature that provides conflicting outcomes, mostly negative consequences of the use of the IAF as MTG, this study's results reveal MTG internal auditors' fraud risk assessments and control risk assessments are not significantly different than those of career internal auditors. These findings extend the IAF literature in the areas of internal auditor judgments.

In summary, I discuss these results offer implications for academic researchers, practitioners, and policymakers in the relatively new topic of IA type involving MTG internal auditors and career internal auditors. First, the study's results inform practitioners and policymakers, including the findings that offer significant contributions to the internal audit profession and the IIA. Second, the study's results inform academics. This study is subject to several standard limitations applicable to experimental (survey) design and survey research based on case study material. Finally, the study's findings raise research questions and offer future research areas.