Do Internal Auditors Have a Comparative Advantage Over External Auditors in Obtaining and Assessing Information about Internal Control Weaknesses?

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Executive Summary

Since the enactment of the Sarbanes-Oxley Act of 2002 (SOX), internal auditors (IA) throughout the world have been forced to take on dual roles within their organizations (Roth, 2002). On one hand, they are expected to maintain a professional identity by acting as the internal "watch dog" for the organization.[1] In this role they are expected to be independent and objective in their assessments of the firm's systems of internal control allowing external auditors (external auditor) to rely on their work (SAS 65, CAS 610, ISA 610). On the other hand, internal auditors are also expected to maintain an employee identity by acting as the "trusted insider" who advises and consults on improving the organization's system of internal controls. The question then arises whether these dual and potentially conflicting identities improve or detract from the internal auditor's overall evaluation of the firm's system of internal control.

The Institute of Internal Auditors (IIA), which is an international organization, believes the internal auditor's role as an organizational insider allows the internal auditor to have a stronger understanding of the organization's internal controls and helps to ensure the identification of any control system weaknesses (Chadwick, 2000; Fitzpatrick, 2001). Critics argue that the relationships the internal auditor develops within the organization will affect their objectivity when asked to assess the organization's internal controls. The objective of the current study is to ask whether it is possible

[1] Identity is formed through the affiliation with a specific group that has developed a set of social norms required of all members (King, 2002; Akerlof and Kranton, 2009).

for both points of view to be correct, at least to some degree, and further, can internal auditors actually use these dual identities to an advantage?

Research Objectives

More specifically, this research project attempts to answer the following two research questions. First, does the "insider" identity the internal auditor assumes within the organization allow for the opportunity to discover more weaknesses concerning the internal controls of their organization than an external auditor? Particularly, will employees share more information about internal control weaknesses with the internal auditor than the external auditor? Second, can the internal auditor move readily from one identity to the other (becoming the professional auditor) and assess internal control information objectively? Particularly, will the internal auditor be able to objectively assess internal control weaknesses so that the external auditor can be confident in relying on the internal auditor's work?

Literature Review

Several strands of prior research suggest the internal auditor may have an advantage over the external auditor in collecting information about internal control weaknesses. For example, research in "organizational silence" indicates that employees are more willing to share negative information within their organization than outside of it (Tangirala and Ramanujam, 2008; Van Dyne et al., 2003).[2] The knowledge sharing literature also shows that the trust that builds in close relationships will affect how much information will be shared within that relationship (Lin, 2005; Wang and Noe, 2010). According to social identity theory (SIT), in-group members trust other in-group members more than they trust out-group members (Ashforth et al., 2008). SIT has also shown that individuals will share more information with their in-group than their out-group (Ashforth et al., 2008). The connection the internal auditor has with the organization should allow the internal auditor to become part of the

[2] Organizational silence is defined by Van Dyne et al. (2003) as the intentional withholding of relevant information, opinions or ideas within an organization, by one of the organization's employees.

organizational in-group. Therefore, the internal auditor in his/her role as a trusted internal advisor is likely to obtain higher in-group status with other employees than will the external auditor. If this in-group status is salient to employees during the internal auditor's internal control interview process, then it is likely that employees will share more information about the internal control system and its workings with the internal auditor than they would share with the external auditor. Therefore, it is possible that the internal auditor will not only obtain more information from employees concerning the firm's system of internal controls, but also potentially more information about control system weaknesses than would an organizational outsider.

Although this is a benefit of the internal auditor's in-group status, there is also a potential cost of in-group status in terms of internal auditor objectivity. To attenuate any bias the internal auditor's in-group status may cause, the internal auditor needs to be able to switch identities, from "insider" to "auditor" when assessing the obtained information. Previous work has shown that members of the IIA have been able to resist threats to their objectivity when their IIA membership status is made salient to them (Harrell et al., 1989). Therefore, increasing the salience of the internal auditor's professional identity, defined as a close affiliation with a professional organization (King, 2002), should allow them to provide a more objective evaluation of internal controls.

Research Design and Results

I explore these ideas through two separate experiments.

Experiment 1. The first experiment examines whether the internal auditor can actually obtain more negative information about control system weaknesses from employees than can an external auditor as predicted by the organizational silence literature. To investigate this question, I manipulate interviewer type (internal auditor/external auditor) between-subjects and internal control weakness severity (high/low) within subjects. Based on social identity theory and the organizational silence literature, I predict that overall, participants will share more information with the internal auditor than the external auditor. This effect will be magnified by the severity of the internal control weakness.).

Results. My results support these predictions that, in general, employees are willing to share internal control weaknesses more with internal auditors than external auditors. More specifically as severity of the weakness increases, the difference between the internal auditor and external auditor will be magnified.

Experiment 2: The second experiment investigates the degree to which cueing the internal auditor's professional norms with the IIA code of ethics helps the internal auditor to remain objective when assessing the severity of identified internal control weaknesses. In this experiment I will manipulate two factors between subjects; organizational identity (internal auditor assess own organization/internal auditor assess another organization) and professional norm salience (IIA code of ethics salient/IIA code of ethics non-salient). I also use an external auditor control group to better understand if salient internal auditor professional norms are important to the external auditors' reliance judgment. To do this I will manipulate whether the external auditor is aware that the internal auditor has agreed to adhere to a professional code of ethics or not. External auditors in practice have expressed concern the internal auditor will be too attached to their organization and will therefore make biased assessments (Desai et al., 2011). Knowing the internal auditor has agreed to adhere to a professional code of ethics may increase the external auditor's evaluation of internal auditor objectivity and consequently, their willingness to rely on the internal auditor's work.

Results. My results for study two are not as straight forward as study one. First, I only find some support that internal auditors with a strong organizational identity rate the IC weaknesses less severely than both weak organizational identity internal auditors and external auditors. However, I do find strong support that salient professional norms do have an impact on strong organizational identity internal auditors in that they rate IC weaknesses more severely than weak organizational identity internal auditors and external auditors. This means the professional norms may even make the strong organizational identity internal auditors overly conservative in their assessment. Finally, I find strong support that when the external auditor knows the internal auditor follows strong professional standards, that external auditor will be more willing to rely on the internal auditor.

Impact of Findings on Existing Literature

This paper contributes to existing literature in several ways. First, Messier (2010) argues the recent financial scandals and resulting SOX legislation have increased the importance of the work of the internal auditor in ensuring the quality of firms' financial disclosures. Second, most of the recent internal auditor literature has focused on the potential for reduction of audit fees through the reliance of the external auditor on the internal auditor or on measuring the quality of the internal auditor's work (Gramling et al., 2012; Prawitt et al., 2010; Glover et al., 2008; Felix et al., 2001). These studies, while important, do not focus on the potential differences in quantity and type of information obtained by internal auditors and external auditors. Third, there have recently been some conflicting views expressed in the literature on the degree to which the internal auditor can remain objective. Finally, previous studies of SIT in psychology have typically focused on why identity matters, but they have not generally looked at the consequences this identity may have on the sharing of negative information; therefore, it is important to explore the conditions in which employees will share more negative information with the internal and/or external auditors.

Impact of Findings on Internal Audit Practice

This study contributes to practice in several ways. First, regulators who have promoted the idea that external auditors can or should rely more heavily on the internal auditor through SAS 65, ISA 610, CAS 610 and AS 5, would be interested to know the conditions the internal auditor can obtain more pertinent information for the internal control assessment than the external auditor and the conditions in which the internal auditor can remain objective when performing their internal control assessment. Also, firms would be able to expect their external auditors to rely more heavily on the internal auditor's control assessments, thus helping to reduce audit fees. Lastly, external auditors would know that relying more heavily on the work of the internal auditor could improve their audit process. More specifically, if the internal auditor is competent, then the additional negative information provided to the internal auditor by employees would allow the internal auditor to conduct a more accurate internal control assessment than could be performed by the external auditor. Therefore, if the external auditor can rely on the internal auditor, the external auditor may feel confident that the internal control assessment will be of a higher quality.

