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Review Paper

INDEPENDENCE AND OBJECTIVITY OF INTERNAL AUDITORS AS DETERMINANTS OF THEIR EFFECTIVENESS

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Abstract. *The aim of this paper is to highlight the issue of independence and objectivity of internal auditors, which, given the place and role of internal audit in the system of corporate governance, is increasingly gaining in importance. In determining these concepts, the difference between them is pointed out, with particular emphasis on their importance for internal audit effectiveness. By introducing circumstances in which internal audit functions, the paper especially emphasizes the challenges that internal auditors face in achieving independence and objectivity in their work. In this process, they receive significant support from regulatory decisions regarding the position of internal audit in companies, and especially directions to invest efforts and eliminate all factors that threaten to undermine their independence and objectivity.*

Key words: *internal audit, independence, objectivity, specifics and efforts to ensure independence and objectivity*

JEL Classification: M42

INTRODUCTION

At the present stage of development, internal audit is a function integrated into the system of corporate governance, which provides assurance of effectiveness of all business functions in the company and consulting services to all management structures in carrying out their responsibilities. In this way, it proactively focuses on creating added value for the company. However, producing corresponding effects, i.e. realization of the strategic role, largely depends on independence and objectivity of internal auditors, as well as the fundamental concepts underlying their work.

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True, independence and objectivity have always represented the cornerstone of audit theory and practice, though, in the last twenty years, these concepts have especially gained in importance. This is because, as a response to the need to improve the system of corporate governance, internal audit received a dual role, associating it with other participants in the system. Such a unique position has made the issue of independence and objectivity a much larger challenge that must be responded to.

In line with the above, the paper is designed to first clarify what is meant by independence and objectivity of internal auditors, as concepts often mentioned in the same context. Then it goes on to perceive the specifics of ensuring independence and objectivity of internal auditors, arising from their position in the company and the role they play in the system of corporate governance. The last part of the paper presents the efforts of professional bodies, especially internal auditors themselves, in ensuring and preserving independence and objectivity.

1. Independence and Objectivity – The Fundamental Concepts of Internal Audit

Achieving independence and objectivity in work is one of the critical preconditions that internal auditors need to meet to serve the purpose. Only independent and objective internal audit ensures the survival of the profession, which is why the significance of these concepts for internal auditors is often compared to Hippocratic Oath for physicians (Christopher et al., 2009, p.201). Even the very definition of internal audit emphasizes that it is "…an independent, objective assurance and consulting activity..."

True, independence and objectivity are strongly related categories and are often mentioned in the same context. However, these are different attributes that standards define in the following manner (ISPPIA 1100):

"Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner".

"Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others".

Further delineation of these concepts is particularly emphasized in the practical guide "Independence and objectivity", which determines objectivity as a state of mind, and independence as a state of affairs (Jameson, 2011, p. 4). Mutchler (2003) differentiates between these concepts in a similar manner, and describes objectivity as a desirable characteristic of an individual, or the audit team, while independence is the desired characteristic of the environment in which internal audit is performed. In this sense, objectivity is linked to an auditor's individual view, their behavior, personal relationship with others, and, when performing engagements – a sincere belief in their work product and that no quality compromises are made. On the other hand, independence means ensuring the possibility of objective performance of internal auditor's duties, and is linked to the organizational positioning of internal audit in the company, reporting relationships with boards of directors, audit committee, or other governing bodies separated from the management, authority for the evaluation of information, reports, and the like. In doing so, although the previous can suggest that independence is emphasized at the organizational level, the definition shows that it is “equally important at the individual, functional, and level of individual engagement” (Stewart & Subramaniam, 2010, p. 330).

The fact is that objectivity of internal auditors does not mean concomitantly their independence, and vice versa, independence of internal auditors does not necessarily mean their objectivity. However, it can be said that the basis of ensuring internal audit independence is, in fact, ensuring objectivity in work and proper management of threats to its achievement. In particular, timely identification and elimination of threats that can compromise the objectivity of internal auditors is a prerequisite for the implementation of activities that contribute to internal audit independence, relating to: adequate organizational position of internal audit, establishing a strong control system, adoption of audit charter, establishing the practice of employment and dismissal of internal auditors, and others. In this respect, self-reliance in work and refusal to subordinate one’s own judgment to the interests of others, but also one’s own personal interest, is something internal auditors must achieve at every stage of their work. According to Mautz and Sharaf, pioneers in the development of auditing theory, independence, i.e. freedom from undue control and pressure must be exercised through:

- Investigative independence – in the selection of areas, relationships, and management policies to be examined,
- Programming independence – when selecting audit techniques and procedures, and
- Reporting independence – statement of audit information obtained by the auditor during the implementation of audit procedure (according to: Andrić et al., 2012).

Code of Ethics for internal auditors also emphasizes objectivity as a principle by which internal auditors must exhibit the highest level of professional objectivity in the collection, evaluation, and communication of information about the activity or process being examined ..., free from undue influence of their own interests or the interests of others in the formation of judgments.

2. Specifics of Ensuring Independence and Objectivity of Internal Auditors

Internal audit functions in two ways: (1) *ex post* – as a provider of objective assurance of efficiency and effectiveness of operations, and (2) *ex ante* – as a catalyst for change by providing advice and guidance in work, which has provided this function a position that provides assistance to all other participants in the system of corporate governance, above all, management. However, its dual role and a unique position in the company are at the same time the cause of specifics of ensuring internal auditors’ independence and objectivity. This is because internal auditors, as company employees, exercise control and provide assurance of the adequacy of the established governance structure and business activities. Hence, it is logical to open a number of issues concerning the possibility of internal auditors to independently and objectively carry out their activities. This primarily refers to the possibility of threats from social pressures by the company management, as well as those arising from personal relationships or intimacy, which is why internal auditors can often be the subjects of conflict. Also, practice has shown that company managers require internal audit to expand its activities outside the scope of its work, in order to compensate for the loss of control as a result of the significant complexity of operations (Sarens and De Beelde, 2006). Internal auditors are often treated as their workers, who are expected to be involved and provide assistance in performing daily management activities. It is also not uncommon for managers to perceive internal auditors as partners with whom they need to work closely to achieve the "common goals", rather than a function that provides assurance of the effectiveness and efficiency of the company processes (Christopher et al., 2009, p. 208). Such management expectations are certainly a serious threat to internal auditors' independent and objective performance of activities within the scope of their work.

Besides, the fact is that, by providing consulting services, internal audit obtains a strategically important position in the company, as it applies a proactive approach to the management process. This, however, may cause internal auditors' bias, because, quite often, auditors need to provide assurance on the efficiency and effectiveness of a process or activity for which they previously made a recommendation for improvement. Nevertheless, although this view is completely logical and relevant, numerous studies show that internal auditors do not fully agree with it. Paape et al. (2003) explored the role of internal audit in 15 European countries, and found that 61% of surveyed internal auditors disagreed with the suggestion that they would significantly preserve their independence if they did not accept advisory role. Also, research by Ahmad and Taylor (2009) has shown that internal auditors do not find a significant link between the occurrence of the conflict, on the one hand, and carrying a double role, on the other. Peurs (2004) dealt with the similar topic and found that most respondents did not see as a problem at the same time assisting company management and independent assessment of the management process. What is more, the perception of internal auditors themselves, that their independence and objectivity are compromised by performing dual roles, is caused by multiple factors: the nature of consulting activities carried out, the existing ownership structure of the company in which they work, the established system of management, and others. This is confirmed by research conducted by Selim et al. (2009), in which they performed a comparative analysis of the extent to which internal audit in companies in Ireland and Italy is involved in providing advisory services and its impact on, among other things, independence and objectivity. The results showed that 36% of respondents in Italy believed that, by providing advisory services, internal audit is able to increase its independence and objectivity, while 38% of respondents in Ireland had a different opinion – dual role decreases independence and objectivity. Also, 64% of respondents in Ireland considered that the risk of conflict of interest largely stems precisely from the dual role of internal audit, while 51% of respondents in Italy believed that this role has no effect on the achieved independence and objectivity. The authors explained the observed differences by the fact that internal auditors in Ireland are involved in providing advisory services related to a wide range of activities in the company, as opposed to auditors in Italy, who traditionally focus on financial audit. Also, Italy has a greater number of the so-called family businesses, so, besides the generally lower concern about achieving independence and objectivity, the existence of personal/family relationships is another reason.

However, despite the beliefs of internal auditors that providing consulting services is not a factor impairing their independence and objectivity, research by Brody and Lowe (2000) suggests otherwise. The purpose of their study was to determine the way in which internal auditors perceive their advisory role – as something that should provide objective information to managers, or as service that should provide solutions in the best interest of the company. In this sense, their research focused on assessing the level of the achieved objectivity of internal auditors in the process of company acquisition. The results showed that the reasoning of internal auditors varied significantly depending on whether they worked in a company that was a buyer or a seller. Specifically, the study has found that most internal auditors (67.76%), which were in the process of negotiations on the side of the buying company, overestimated the likelihood of inventory obsolescence to achieve lower prices, as opposed to internal auditors on the side of the seller (37.31%). This data indicates that internal auditors are biased and prone to satisfying the interests of their company, following that the provision of consulting services makes them unable to maintain their independence and objectivity. That this is not an isolated case is proven by the results of research conducted by Dickins and O'Reilly's (2009), according to which 89% of 99 audit managers at US companies were involved in various forms of compensation packages. Bearing in mind that compensation packages are conditioned not only by the overall results of company operations, but also the achieved internal audit performance, bias of internal auditors in performing activities is quite logical.

In addition to the dual function they have, specificity of ensuring independence and objectivity of internal auditors resides in the fact that, not infrequently, internal audit is the starting point, i.e. "springboard" for higher management positions. Research by Goodwin and Yeo (2001) shows that 43% of respondents, chief audit executives in enterprises in Singapore, confirm the practice, while in the US, the situation is such in more than half of publicly listed companies (Rose et al., 2013). Also, research by Christopher et al. (2009) shows that 56% of internal auditors in Australian companies believe that the appointment of internal auditors to higher managerial positions is, in fact, a reflection of the business culture. An argument for this practice is that internal auditors carry out their assurance and consultation role in a number of different company functions, which includes a good knowledge of how to perform the activities and manage these functions. Appointing managers, who, based on previous experience in internal audit, stand for well-trained staff, with an excellent understanding of almost the entire company operations, is certainly a significant benefit for the company. However, this may in turn lead to a number of risks to the achievement of independence and objectivity of internal auditors. More specifically, it is a reasonable assumption that internal auditors will, to some extent, be biased in carrying out their activities, bearing in mind that the audited entity has concrete plans to develop their careers. Independence and objectivity is surely brought into question as a result of internal auditors' desire "not to compromise their relationship with the counterparts and not to be characterized as unreliable and untrustworthy colleagues" (Rose et al., 2013, p. 1008). In addition, internal auditors hoping or expecting to move to senior management functions are not sufficiently interested to adequately carry out their activities and show no initiative to improve audit quality.

3. Efforts to Ensure Independence and Objectivity

The fact that only independent and objective internal audit may produce corresponding effects fully justifies the IIA efforts to, by making a significant number of standards and related practical advice, ensure compliance with these concepts. Thus, the standard 1100 states that internal audit activity must be independent, and internal auditors' objective in performing their duties. This standard is followed by interpretation, according to which an internal auditor should have direct and unrestricted access to senior management and the board, which is actually achieved by double reporting line. This issue is further determined in the standard 1110, according to which the chief audit executive must report to the management level in the company, which allows the internal audit activity to fulfill its obligations. In this sense, organizational independence is achieved when the chief audit executive functionally reports on its work to the audit committee and administratively to senior management level, where functional reporting includes all the issues relating to the scope of internal audit, from planning to reporting on work results, including the quality control of internal audit activities, while administrative reporting involves communication with the appropriate higher management level on administrative matters related to the daily operations of this function.

Standard 1120 promotes personal objectivity of internal auditors, according to which internal auditors must have an objective and impartial attitude in the performance of their tasks. Also, they must avoid any conflict of interest that may reduce confidence in the internal auditor, the internal audit activity and the profession, and in related Practice Advisory 1120-1, considerable personal responsibility in this regard belongs to the chief audit executive, who should, whenever possible, periodically rotate tasks of internal audit staff.

Finally, standard 1130 points to the obligation of disclosure of details of impairment to independence and objectivity of internal audit. Abundant Practice Advisory related to this standard indicates causes of impairment to independence and objectivity, and responsibilities of internal auditors and chief audit executives to disclose details of impairment and adequately react in these situations. The importance of identifying threats to achieving a high level of independence and objectivity has made IIA give them special attention in their practical guide. Thus, impairing objectivity may result from (Jameson, 2011, p. 7-9):

- Social pressure on internal auditors when external auditors, regulators, management, and others consider that any internal audit engagement must generate certain findings, or when management expects that auditors "overlook" suspicious items, etc.;
- Economic interests, in the sense that an internal auditor's negative findings may impact future company operations, and, thus, the realization of their economic benefit as company employee, or in situations where work or department of individuals who directly influence the internal auditor's status and salary is audited;
- Personal (family) relationships or intimacy, as a result of long-term co-operation, between internal auditors and individuals whose work or department is audited;
- Cultural, racial or gender bias of internal auditors;
- Psychological bias of internal auditors about the role they perform – if auditors have a critical perspective of internal audit, it is very likely that they will overlook the positive things and vice versa, the perception of internal audit as a facilitator for improvement can cause them to overlook negative things;
- Audit of auditor's own work, in the sense that audit focuses on activity, process or work of the department for which the auditor previously, serving as a consultant, gave a recommendation for improvement;
- Threats or intimidation of the internal auditor by the audit client or other stakeholders.

In addition to standards and Practice Advisory, IIA Code of Ethics provides that internal auditors should not participate in any action or attitude (as opposed to the interests of the organization), or accept anything that might impair or seemingly undermine their professional judgment or independent appraisal. Furthermore, they must disclose all material facts with which they are familiar, and which could, were they not disclosed, distort the reporting of activities which were subject to audit.

However, despite the existence of professional regulations, independence and objectivity of auditors are much higher requirements than those imposed by rules, because it is not realistic to expect that explicit rules will cover all potential sources of bias. At the same time, they are neither a guarantee, since independence is the subjective characteristics of the individual that is difficult to quantify (Andrić et al., 2012, p. 86). Independence and objectivity of internal auditors primarily depend on their relations with the governing bodies of the company, from the support they receive at work, and then the skills of internal auditors to withstand various threats.

3.1. Establishing appropriate relations with management and the audit committee

Establishing clear and, above all, fair and constructive relations between internal audit, on the one hand, and company management and the audit committee, on the other, is a precondition of an adequate organizational position of internal audit. In this regard, relations between internal auditors and management are complex in particular, due to their close cooperation that has to be achieved in order to provide mutual support in performing activities, all in order to create added value for the company. This cooperation is necessary; however, it is reasonable to question the extent to which internal auditors can remain independent if they bind and directly subordinate their activities to management; what should be the limits of their cooperation? Looking for an adequate response imposed the view that the relationship between internal audit and management should be constructive and balanced – neither too friendly nor unfriendly (European Confederation of Institutes of Internal Auditing, 2005). Such a relationship is shown in Figure 1.

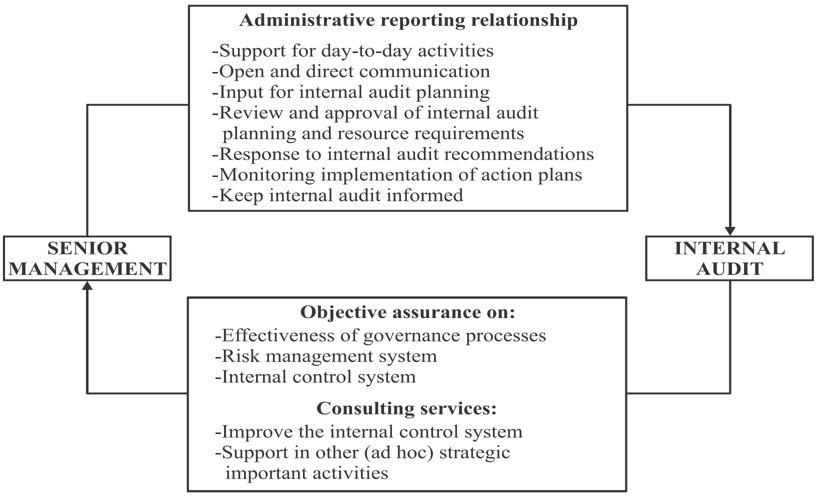

Fig. 2 Relationship between internal audit and senior management
Source: Sarens & De Beelde, 2006, p. 224

The figure clearly shows that internal audit provides assurance and consulting services, thus providing significant support to company managers in the management and implementation of strategic goals. For these reasons, it should align its objectives with the strategic objectives set by the management, and focus its activities on areas which the management believes are the key to success. On the other hand, company management is also expected to provide significant support to internal audit in performing its activities. This support is determined in Performance Standards, and, thus, standard 2010 states that management should provide significant inputs when creating audit plans, with the aim of pointing out high risk areas or business opportunities. Furthermore, standard 2020 prescribes that the chief audit executive is obliged to inform the management about the planned activities and resource requirements, including any significant changes that have occurred in the meantime, in order to determine whether internal audit objectives and activity plans reflect company plans. And, finally, in order to examine the possibilities of overcoming possibly identified problems, according to Performance Standard 2060, company management, next to the board, must obtain an internal audit report on the purpose, authority, and responsibilities of internal audit, and performance in relation to the plan.

Such a relationship should ensure the achievement of synergistic effects and directly contribute to the improvement of company management, while providing the ability to achieve a high level of independence and objectivity of internal audit. Managers are the ones who largely orient internal audit activities and provide support for the performance of audit activities. However, this does not mean that internal auditors should be considered as their "servants", and that the impact on their work should go beyond the powers of management. Thus, provision of inputs for internal audit plans and consideration of requests for resources, together with the audit committee, is desired and prescribed by standards, but internal auditors and the audit committee should have full autonomy for the final prioritization. This is because if management does not want internal audit to focus on some specific areas, they can limit internal audit resources, and, thus, significantly reduce audit activity (Christopher et al., 2009). Also, the issue of employment and dismissal of internal auditors should not be the responsibility of the company managers as audited entities, for direct subordination of internal auditors and bringing their independence and objectivity into risk.

Based on the above, it can be concluded that "the greater the influence of management on internal auditors, the less they are independent in carrying out the tasks entrusted to them" (Kondić & Petrović, 2012, p. 133), which is why establishing a balanced relationship to provide both sides with an opportunity for the proper performance of tasks entrusted to them is a priority.

Unlike company management, greater involvement of the audit committee in internal audit activities is desirable or necessary, because it is an authority with the primary responsibility for the effective functioning of internal audit. The relationship between internal audit and the audit committee is "much more than relationship between the supervised and the supervisor" (Goodwin & Yeo, 2001, p. 110), because the audit committee primarily focuses on safeguarding the independence of internal audit from management (Kamau et al., 2014). This is primarily achieved by:

- *Approval of internal audit charter/rulebook*, which sends a special message to management that chief audit executive may appeal to a higher authority in the case of controversial issues. Approval of the charter implies that internal audit is free from barriers that might otherwise prevent it from making the necessary disclosures to the audit committee;

- *Approving risk-based internal audit plan and budget* – based on a risk study prepared by internal auditors and significant inputs received from the company management, chief audit executive shall submit to the audit committee a draft plan, which they, as the ultimate coordinator, review and finally approve;
- *Receiving reports from the chief audit executive* on the execution of internal audit activities in relation to the plan and on other matters and measures related to significant audit findings in the report that their internal auditors provided;
- *Approving decisions concerning the appointment and dismissal of chief audit executive*. Although chief audit executive is, as a rule, administratively responsible to company management, audit committee is responsible for their recruitment and dismissal. Company management informs the audit committee of potential candidates and makes a proposal. Also, management can make a strong statement of reasons why the current chief audit executive is not fulfilling their responsibilities and that they should be transferred or dismissed. After the company management's decision proposal, audit committee makes the final decision on appointment or dismissal of chief audit executive.

By performing these activities, audit committee ensures that internal audit activity is structured in a way that ensures organizational independence. Additional support to internal audit comes from complete and unrestricted access to documents and people within the company. Also, the possibility of direct and regular communication between the chief audit executive and the audit committee chairman, attending committee meetings to discuss internal audit plan, significant findings, methods of implementation of recommendations, and others further support the independence of internal audit. The great importance here belongs to private meetings between the chief audit executive and the audit committee, bearing in mind that they often discuss sensitive internal audit findings, for which the presence of the company management is not desirable.

3.2. Threat management to achieve independence and objectivity

Achieving independence and objectivity in work is subject to significant efforts made by internal auditors themselves, aimed at adequate assessment and management of any situation that threatens to endanger them. Significant support in this regard comes from IIA Framework, aimed at promoting and fostering independence and objectivity of internal audit in the company (Jameson, 2011). Specifically, this Framework presents the multi-stage process of threat management, which initially involves *timely identification of any threats* to independence and objectivity. It is the responsibility of internal auditors to even seemingly insignificant events and circumstances that may reduce their ability to freely and impartially carry out their activities recognize as a threat. Initial identification of threats at this stage should be communicated to the chief audit executive for a decision on the organization of a proactive approach to eliminate them.

In the second phase, it is necessary to *assess the significance, i.e. strength of the impact of circumstances or events identified as a threat*, and to distinguish whether it is directed at impairment of independence or objectivity. In addition, it is very important to look at whether it is already present or is expected to appear and intensify in the future. This provides the ability to *identify specific factors to mitigate* the identified threats. More specifically, at this stage, it is important to assess whether it is possible to mitigate the threat and consider how to provide the best results: ensuring support from the audit committee, establishment of legal, i.e. professional penalties and other measures to ensure the smooth performance of tasks. After their application, internal auditors should assess whether and to what extent the threat has been mitigated and the risk of inefficient performance reduced to a minimum. However, internal auditors are expected not to rely on the assumption that measures taken fully eliminated threat. They must *assess the residual risk* of threat, relying on their reasonable judgment. If they assess that there is risk or if they are not completely sure of their independence and objectivity, they must inform the chief audit executive, and, possibly, the board of directors or audit committee. Certainly, internal auditors are expected to *proactively manage the remaining threat*. By using different tools, such as reference to audit charter, segregation of duties, contracting work with third parties, and the like, internal auditors, to the extent possible, complete tasks without bias and impairment.

Regardless of the identification of the mitigating factors and the efforts of both auditors and company management, the possibility of threats that cannot be eliminated yet exists. In such situations, the auditor is expected to *assess the existence of unresolved threats* and, in relation to the corresponding sides, consider the possibility of independent and objective performance of tasks. Very often internal auditors inform users of audit services on the circumstances, and, if, after consultation with them, a decision on further work is made, it is important to consider the implications of the report to be prepared by internal auditors.

Mitigating factors that have been identified, the manner of their implementation, and any measures taken to eliminate threats to independence and objectivity are very important to be *adequately documented*. This document is an important source of information for management structures within the company and external teams performing quality assessment of internal audit, commitment of internal auditors, and efforts to preserve independence and objectivity. In addition, at this stage, it is important to describe in detail the threats that could not be eliminated and the mode of work in these situations.

Proper management of threats to independence and objectivity implies continuity in work. Chief audit executive is expected to, for each audit engagement, conduct a comprehensive review of activities, not only auditors', but also of other employees, aimed at safeguarding independence and objectivity.

CONCLUSION

Full utilization of the internal audit's potentials to improve the corporate governance system is largely conditioned by the independent and objective approach of internal auditors in defining the scope of their work (having full control over the nature of their work), implementing activities (freedom to collect and evaluate evidence) and communicating results (freedom in reporting the results of their work without any pressure). However, the unique place they take in the aforementioned system, as well as the dual roles they have, are the reasons why the independent and objective performance of internal auditors is one of the greatest challenges of modern auditing practice.

The specifics of ensuring independence and objectivity, as determinants of the effective performance of internal auditors, have conditioned that the IIA, as the most influential professional organization in this field, specifically directs its efforts to respect these concepts. In addition to adopting a large number of standards, the IIA provides support to internal auditors through practical advice, guidance, and the like. Apart from respecting professional regulations, internal auditors are expected to be able to recognize and adequately manage any threat of violation of independence and objectivity. In this way they will avoid situations that their independent operation and the possibility of objective professional judgment and decision-making could be questioned.

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NEZAVISNOST I OBJEKTIVNOST INTERNIH REVIZORA KAO DETERMINANTE NJIHOVE EFEKTIVNOSTI

Cilj autora ovog rada jeste isticanje problema nezavisnosti i objektivnosti internih revizora, koje zbog mesta i uloge koju interna revizija zauzima u sistemu korporativnog upravljanja, sve više dobija na značaju. Determinisanjem ovih koncepata ističe se razlika među njima i posebno apostrofira značaj koji imaju za postizanje efektivnosti interne revizije. Predstavljanjem okolnosti u kojima interna revizija deluje, posebno se naglašavaju izazovi sa kojima se interni revizori suočavaju u ostvarivanju nezavisnosti i objektivnosti u radu. Značajnu podršku u tome pružaju ima prikazana regulatorna rešenja u vezi sa pozicioniranjem interne revizije u preduzeću, a posebno usmeravanje internih revizora na ulaganje napora u otklanjanju svih faktora koji prete da im ugroze nezavisnost i objektivnost.

Ključne reči: *interna revizija, nezavisnost, objektivnost, specifičnosti i napori u obezbeđivanju efektivnosti interne revizije*