CHAPTER I

INTRODUCTION

2.1 Background

The practice of internal auditing has been developing for a long time. Historians have determined that in about 3000 B.C scribes of Mesopotamian civilizations utilized elaborate systems of internal controls using dots, ticks, and check marks based on stone documents that has been found. Auditing itself has evolved over millennia, at the beginning of 13th century, the first two official state auditors were appointed in the city of Pisa, which until today we knew that there are two basic types of business auditor: external auditor and internal auditor (Swinkles, 2012). The demands for both external and internal auditing stems from the need to have several independent verification methods to reduce recording errors, misuse of assets, and fraud in business and non-business organizations (Ramamoorti, 2003). External auditor is chartered by regulatory authority to visit an enterprise or an entity and to review and report the result of the review independently. Moeller (2009) stated that internal auditing is broader and interesting field, it usually takes employee or member of an enterprise that independently reviews and assess operations in a wide variety of areas, such as accounting office procedures or manufacturing quality processes. However, external auditors still continue to have a strong influence on the work and approach of internal audit, from the perspective of the external auditor's duties, be a guarantee for reliable financial reports (Swinkles, 2012).

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations (Anderson et al., 2017). IIA (2013) defines the role of internal audit is to provide independent assurance that an organisation's risk management, governance, and internal control processes are operating effectively. Swanson (2010) stated that establishing a strong internal audit function is a long-term and wholesome investment for most organization because internal audit department can act as independent advisor for the board and senior management. Where an organisation has no internal audit department, the identification of the benefits and roles for establishment of internal audit should be considered. Where an internal audit department has been in operation, improvement is recommended based on its recent performance. Internal audit deals with issues that are substantially significant to the survival and prosperity of any organisation. Vallabhaneni (2009) summarized the internal audit activity's role in governance, risk, and control. The activity of internal audit in governance should assess and make appropriate recommendations for improving the governance process in its accomplishment for the objectives: promoting appropriate ethics and values within the organization; ensuring effective organizational performance management and accountability ;effectively communicating risk and control information to appropriate areas of the organization ;effectively coordinating the activities of and communicating information among the board, external and internal auditors, and management (IIA Standard 2130). In the field of risk management, the internal audit acted as consulting role to assist the organisation in identifying, evaluating and implementing risk management

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methodologies and controls to address those risks. Meanwhile, control activity of internal audit should assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. The combination of assurance and consulting by internal auditing that look beyond financial risk and statements to consider extensive issues such as organisation's reputation, growth, environmental impact will help organisations to succeed (IIA, 2020). The function of internal audit department in an enterprise has evolved as the years go by. Lately, internal audit department has become Management Training Ground (MTG) and has been adopted by numerous organisations. Selim et al. (2014) stated that there are two main approaches to implement the method. The first one consists of hiring new employees in the internal audit function with the intention to move them to line management after 2 or 3 years of experience. The second refers to assigning existing employees to work in the internal audit function for a specified period of time before being recycled back to the management. The expected impact for the future is the recruits can become ambassadors and promoters of internal control and governance across the organisation after gaining experience in the internal audit department.

Despite the numerous benefits gained from having internal audit function within the organisation, negative perceptions of internal audit are still emerging from both accounting and non-accounting business professionals (Burton et al. 2015; Bartlett et al. 2016, 2017). Based on a survey conducted by PwC (2017), internal audit only adds 44% significant value reaching the lowest in five years and that half of stakeholders who already receive significant value from internal audit indicate that

they still expect more value than they are currently receiving. Bartlett et al. (2017) has studied the perceptions of internal auditing from extant literature indicates that relevant stakeholders are generally dissatisfied with internal audit functions (IAFs). Similar statement by Sarens et al. (2016) the internal audit value proportion is still not commonly appreciated since the serious challenge of internal audit is having organisational relevance. Eulerich et al. (2017) summarized in their study that the negative stigmas are caused by negative work outcomes, including less ability to add value, less influence in the organization, more resistance to implementing their recommendations, and more pressure to change audit findings. Obert & Munyunguma (2014) claimed negative perceptions of internal audit are caused by people who are after personal gain from company resources. These people think that internal audit will uncover their secrets and attempted to discredit audit as much as possible in order to make the discredited audit report. Negative perceptions of internal audit also come from the auditor itself as self-images of internal auditor. Lenz (2015) clustered the negative self-image into five groups in the form of metaphors caused by non-acceptance of audit and disappointment in the eyes of stakeholders; *police*, *servant*, *consultant, doctor, and change agent*. Not only based on formal research, the emergence of negative perceptions of internal audit also recognized by The President and CEO of Institute of Internal Auditor (IIA), Chambers (2012) stated there are five classic myths about internal auditing; "internal auditors are accountant by training", "nit-pickers and fault-finders", "it's best not to tell the auditors anything unless they specifically ask", "internal auditors follow a boring cycle", "corporate police function" which surprisingly these myths

were still existed in 2020. Sarens et al. (2016) defines the illustration "the eyes and the ears of management" of internal auditor's job reinforce the negative stereotypes associated with what internal audit constitute today. These stereotypes are (a) fatalistic, "those who come onto the battlefield after the battle is over to bayonet the wounded"; (b) pessimistic, "master of Orwellian language" as they assume that everyone else in the organization has bad intentions; (c) cynical, "if your mother tells you she loves you, check it out," because they think that they are the only good ones in the organization. Lastly but not least, Cooper (2008) stated anecdotally that internal audit department is the "dumping ground" for the underperforming employees. The large degree of negative perceptions and stereotypes about internal auditing negatively impact both the size and the quality of internal audit hiring pool (Afriyenti & Sari ,2018; Bartlett et al. ,2017;2015). Burton et al (2015) studied that accounting students are more willing to apply for a positioned labelled "accounting" rather than "internal audit" because they believe there are negative perception of internal audit by business professionals. In hence, internal auditors should be aware of negative perceptions surrounding the profession as the chance for them to make adequate changes to effectively combat stakeholder scepticism about the value of internal audit, which would save the organisation from low quality of corporate governance (Eulerich et al., 2017). In view of numerous negative perceptions of internal audit and how it might affect the quality of internal audit function and the profession, this study seeks to assess factors influencing negative perceptions of internal audit as a literature review.

2.2 Problem Statement

There have been numerous studies touching on the negative perceptions of internal audit by stakeholders, accounting and non-accounting business professionals. Obert et al. (2014) studied the internal audit perceptions only on Zimbabwe area. Bartlett et al. (2015) studied external auditor's perceptions of and willingness to work in internal audit functions. Sarens et al. (2016) studied self-images of internal auditor which mostly are negative. Eulerich et al. (2017) studied the internal audit stigma awareness and the outcome for the internal auditing itself. However, there is no available research that specifically explains why the negative perceptions of internal audit occur. This study therefore examines factors influencing negative perceptions of internal audit as a literature review.

2.3 Objective of the Study

The main objective of this study is to explore the negative perception of internal audit by reading the available articles and discussing them.

2.4 Significance of the Study

This study has several potentials in contributing to the understanding of the work of internal audit in enterprises. Internal audit is very important value addition if the organisation has good understanding of the internal audit function (IAF). However, there are substantial amount of negative perceptions by stakeholders, accounting and non-accounting business professionals. This study aims to increase the awareness of internal audit practitioners about the perceptions of the internal audit itself in order to make continuous improvement of the internal audit function. This

study also will give suggestions about what internal audit should improve in the future in order to satisfy the need of the organisation, so that the negative perceptions will slowly disappear.

2.5 Organization of the Study

This literature review is divided into five chapters. The first chapter is the introductory chapter which includes the background that brings discussion about internal audit ranging from general to specific. It also includes problem statement, objective of the study as well as significance of the study. The second chapter embodies the review of available literatures. The third chapter covers the methods and procedures used in the study, taking qualitative approach as the research design and descriptive review as the research methodology. The fourth chapter presents the discussion of the study about the negative perceptions of internal audit as well as the positive perceptions, impact of the negative perceptions, and expected improvements of internal audit. The last chapter draws conclusion from the discussion and provide recommendations for further research.