

## A SYSTEMATIC REVIEW ON INDEPENDENCE OF INTERNAL AUDITORS

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### **Abstract**

*In this article, literatures about the independence of internal auditors are studied systematically, a prominent area of research in accounting in recent times that is understudied in various aspects. The study has taken into account articles from 2015 forward, including academic works and reports. The literature was searched using pertinent keywords, and after meeting a few inclusion and exclusion criteria, it was selected. A quality assessment has been conducted based on the review evidence. The results have been systematically mapped, and a thematic synthesis was done to combine the results. The findings from studies taken widely represent the corporate governance dimensions, various factors of audit, internal auditors, their independence and audit quality globally. Article's objectivity is to present the various characteristics of the independence of internal auditors that can be researched. The paper shows the literature evidence of how internal auditors are the backbone of internal structure of an organization and that their independence will enhance the growth of an organisation.*

**Keywords:** Audit; Internal Auditors; Independence of Internal Auditors; Corporate Governance; and Financial Performance.

JEL Classification: M19 M42 M48

### **INTRODUCTION**

Corporate governance (CG) is the resolution for the firms, which guides and panels the business to course efficiently. The outline of CG is influenced in India by the structure framed by the Companies Act, 2013 and is regulated by the Ministry of Corporate Affairs (MCA) and the Securities and Exchange Board of India (SEBI) (Governance 101, n.d.). The framework differs for each category of companies based on their capital. As per the corporate governance framework, firms need to align their financial functions, employee management, communication channels, social engagements, and so on, in a manner that benefits all their stakeholders. Traditionally businesses focus on the economic aspects of a company, but corporate governance requires that

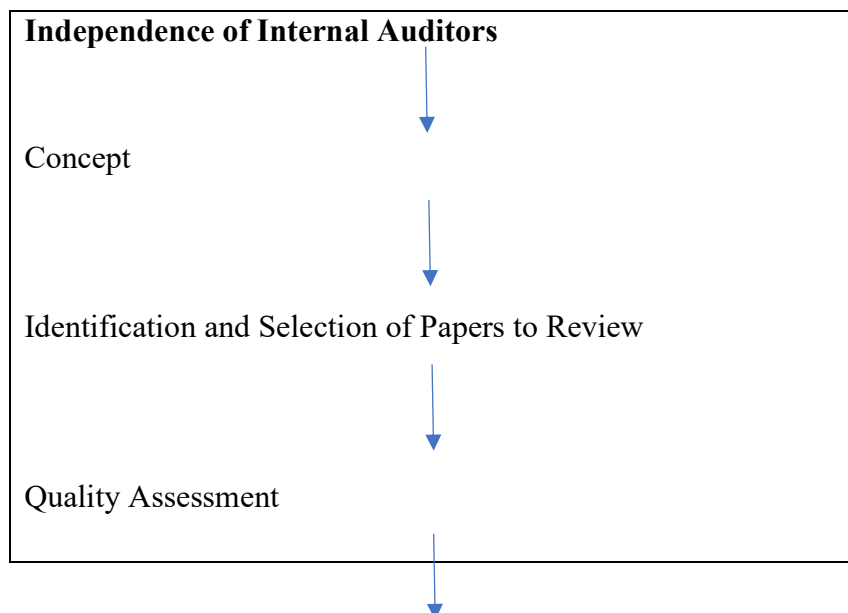
firms give equal focus to social responsibility. The CG framework of a firm should consider the three important dimensions of CG: the board of directors, internal auditors, and external auditors (Mariana Nedelcu (Bunea), 2015).

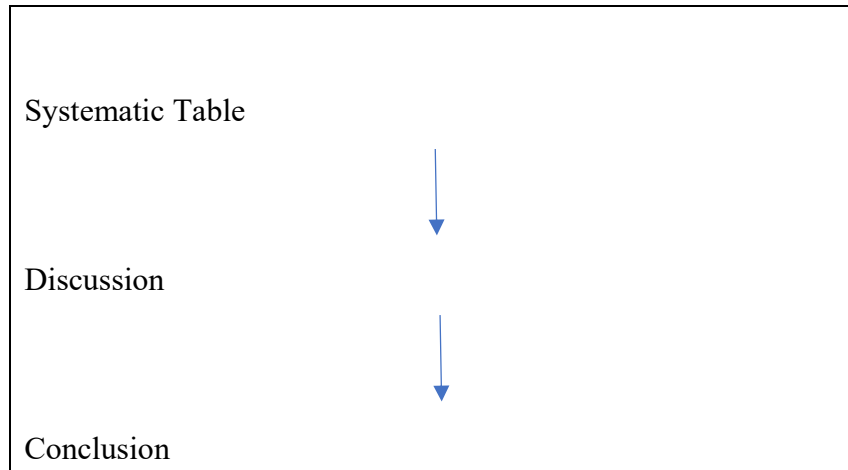
In India, corporate governance emerged in 1966 (Nair, n.d.). It was a general framework applicable to all types of companies. Over the years corporate governance has been improving and becoming more transparent worldwide. The Indian government, which gets their major share of GDP from small scale sectors (Reserve Bank of India - Database, n.d.), started to encourage small firms to issue IPOs to raise funds from the year 2012 (Pareek, 2023) and required that the listed SMEs must adhere to corporate governance mandatorily for their firms. Meanwhile, small firms were not able to achieve the corporate governance agenda due to regulations framed higher than their capacity, hence to solve this issue specific modifications were allowed to the corporate governance framework of SMEs. Worldwide, research studies started to encourage the independent internal audit function in SMEs as per corporate governance framework.

When we see the three CG dimensions and their focus in previous literature, there are considerably more studies on the 'board of directors' and 'external auditors' dimensions, than on 'internal auditors'. Independence is one of the significant features of CG, which is applicable for all three dimensions of CG, but as evident from various research studies, 'independence of auditing' is largely associated only to "external audit work". The present study's focus on independence of internal auditors is seemingly under-researched.

The objective of this article is to review systematically the previous research studies on independence of internal auditors and its effect on the performance of a business, and to fetch the gaps for future studies from the previous research on internal audit.

## METHOD





*Figure 1: Stages of Systematic Review*

## CONCEPT

Internal auditors are those who give assurance and consulting services to the firm on a continuous basis (Jagongo, 2017), whose focus is on improving the operating and financial activities of the firm with appropriate risk management, financial data, management reporting style, amenability of laws and regulations, and so on (Aikins, 2011). Internal auditors are superior to management and have control over management (Jan Svanberga, 2018). As per corporate governance: internal auditors, external auditors and the board of directors, are the three departments who need to follow up the firm's activities and align them as per the regulations in order to benefit the interest of various stakeholders with accurate information.

Independent auditors refer to both internal auditors and external auditors (Saidin, 2014), denoting that their role is based on an honest and objective system towards auditing that is without being influenced by the management or auditing favourably towards the company. The internal auditors usually assume themselves to be independent, whereas the independence of is assessed by independent external auditors based on their objectivity and competence (Ward & Robertson, 1980). Internal auditor being himself an insider of the company with financial benefits, their independence will affect themselves and also affect others with financial interest in the company. This raises a question on earnings management in the financial records of the firm (Alzoubi, 2017). An internal audit function that is independent are said to return a company better financially according to many researchers. External auditors' opinion can impact the company qualitatively, whereas internal auditing can impact the company financially (Ewald Aschauer, 2015). and most stakeholders are not aware of the influential role of internal auditors. If this information is made aware to the companies, they will be more serious towards the internal audit function (Ewald Aschauer, 2015) (Booker, 2018).

## Identification and Selection of Papers to Review

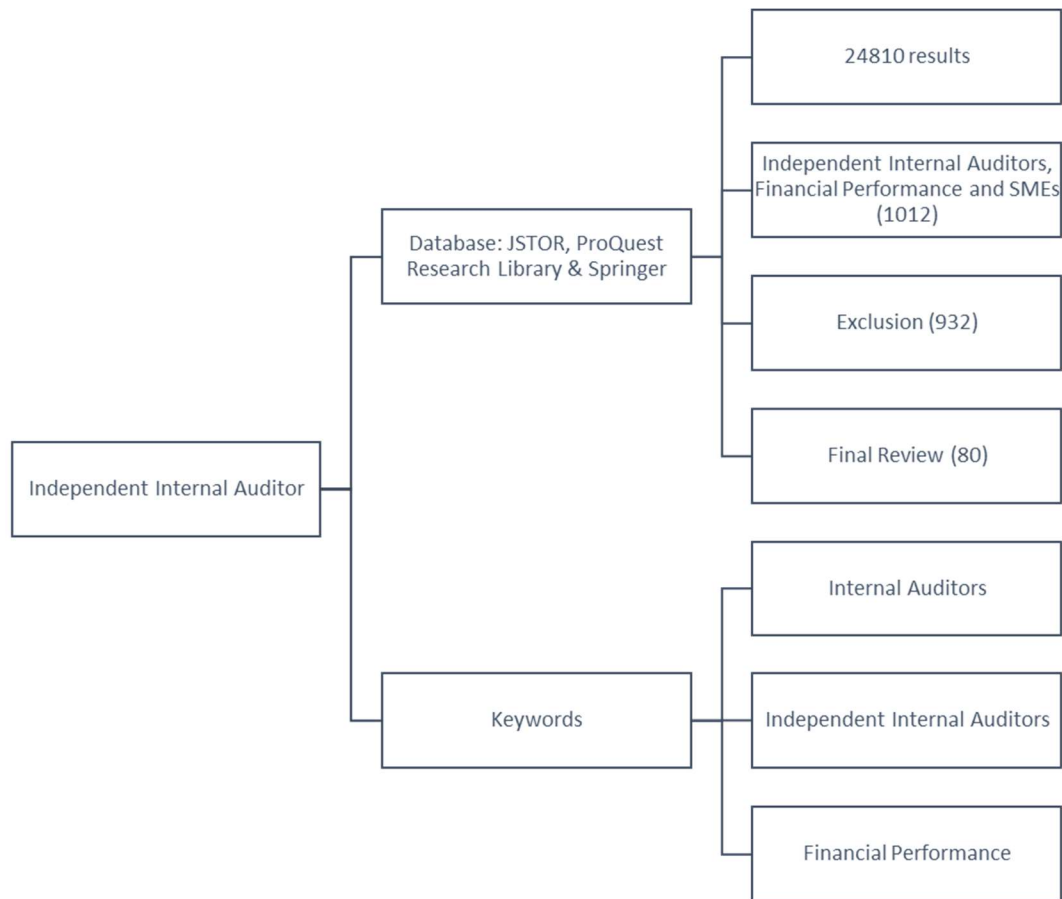


Figure 2: Methodological Approach (Chandan R Honavar, 2020)

The figure above is adapted from the article "Application of Framing in Leadership Communication: A Systematic Review and Research Agenda" by Chandan R Honavar, Krishna Bhargav K L, and Dr Theresa Nithila Vincent (Chandan R Honavar, 2020). One of the key topics in accounting research is Internal audit (Eulerich, 2019), hence the study strived to research specific aspects of internal auditing, and understood there is a gap in the concept of ‘independence’ among the internal auditors. To further narrow down the gap, literatures on ‘Independent Internal Auditor’ was reviewed systematically. Further to narrow down our perspective and variables, we increased our search terms and categorized them into three main terms: ‘Internal Auditor’, ‘Independent Internal Auditor’ and ‘Financial Performance’.

Initially, we got the search result as 24810 articles from the three databases: JSTOR, ProQuest Research Library, and Springer. When we specified our search terms with added keywords, the result was reduced to 1012, and after various exclusions, we got around 80 articles to review. The breakup of the search results from the three databases is as follows:

**Table 1: Breakup of the search results**

Database	Keyword – Internal Auditor	Keyword – IIA, Financial Performance.	Exclusion	Final Review
JSTOR	31	21	20	1
ProQuest Research Library	20961	858	855	3
Springer	3818	133	57	76
<b>Total</b>	<b>24810</b>	<b>1012</b>	<b>932</b>	<b>80</b>

**Table 2: Inclusion and Exclusion Criteria**

Features	Inclusion Criteria	Exclusion Criteria
Publication Category	Peer Reviewed Journals, Scholarly Journals, reports, dissertations and thesis	Books, Magazines, Conference reports.
Publication Language	English	Except English
Key Words	Title, abstract	Reference
Year of Publication	Years from 2015 to 2021.	Years before 2015

## QUALITY ASSESSMENT

Weight of evidence is used to assess the quality of the literatures considered for reviewing, based on the article "Weight of Evidence: A Framework for the Appraisal of the Quality and Relevance of Evidence" by Gough, David (2007). The following is the model of the framework:

<p>Weight of Evidence A</p> <p>This is based on generics, that is, without review, the judgment on the quality of the paper is passed. The quality focuses on honesty, a strong moral principle, logic, and consistency of the evidence. This is the most basic and generally used concept of assessing an evidence’s quality.</p> <p>Weight of Evidence B</p> <p>This judgment is passed based on the review of the entire evidence, focusing on the answer for the research question. Which is directed based on the relevance of information.</p> <p>Weight of Evidence C</p> <p>This judgment is also passed based on the review of the evidence. This quality assessment also gives answers to other major parts of the research question, specifically the relevance of the evidence.</p> <p>Weight of Evidence D</p> <p>Complete assessment by combining the quality assessed of the evidence under weights A, B, and C. So, this weight of evidence will show the extent to which an item of evidence answers the research question by reviewing it.</p>
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Figure 3: Weight of Evidence Framework. Gough, David (2007)

Table 4: Application of WoE Framework (George, 2016)

The table is as per the model given in “Subjective well-being of children in India: A systematic review” by Alka Ranjan and Tony Sam George.

Criteria for WoE	Implication in the Reviews
A - Quality of Research	Here, the quality of literature is weighted on the model of the study.
B - Research Design	Research design is weighed based on the review of an evidence’s variables, sample, and methodology.
C - Research Relevance	Relevance of the literatures weighed as per the review of the evidence answering the research question of this study.

The quality assessment is carried out and evaluated according to Gough’s (2007) model (Gough, 2007); each literature was given a ranking under the three WoE (A, B and C), the ranking for each WoE were ranging from 1 to 3; the ranks for all three weights were added, the maximum ranking total is 9 and minimum ranking total is 3: the literature with total rank ranging from 6 to 9 were considered as good quality. Most of the studies had a weight denoting good quality, but a few studies with low quality were also included in order to understand the incomplete aspects of the studies. Out of the 80 articles, 21 articles are classified for the literature review; the rest, 59, are used for the empirical analysis as presented in Table 5.

**SYSTEMATIC TABLE**

Table 5: Empirical Analysis

Category	Subcategory	Findings
Internal Auditors	Corporate Governance, Audit Committee, Internal Audit Function and Internal Management	For better independence in internal audit work, there should be high support from internal management and the audit committee, which will also impact financial performance positively. But if management competes with internal auditors, they will try to influence internal auditors for their own benefits, and independence will be difficult and the relationship between auditees and auditors will not hold good. The audit committee should control internal auditors with proper guidelines and continuous supervision for good audit quality to impact financial performance positively.
	External Auditor’s Reliance on Internal Auditors	When external auditors depend on internal auditors’ work, it is said to have a positive effect on the external auditor’s style of work. In the opinion of internal auditors on reliance, the work burden of external auditors is reduced, whereas external auditors' opinions contrast this. Another study likewise shows reliance on internal auditors' work can reduce external auditors' workload and the fee paid to them. The Institution of Internal Auditors encourages

		for the better objectivity and competence of independent internal auditors and their audit quality.
	Internal Control System	Internal control systems are said to have good knowledge and assessment skills about fraud risk factors, which is also the key role of internal auditors (IA); therefore, a good connection between the Internal Control System (ICS) and IA will help in effective measures on fraud risk assessment.
	Tenure, Distance, Non-Audit Service and Outsourcing	When the Internal Audit Function (IAF) is outsourced, it indicates the low efficiency of the ICS and the loss of confidentiality, but it enables transparency of information favourable to investors. When auditors are at a long distance from the client's location, it is better to have a rotation of auditors so as to reduce the internal control weaknesses and it is said to lose the independence in auditors' work when non-audit services are offered.
	Information Technology	Information Technology in Internal Audit Function can be effective and efficient towards the performance of the firm.



<p>Independent Auditors (Internal Auditor)</p>	<p>External Auditors Reliance on Internal Auditor's Independence</p>	<p>External auditors will fix their degree of reliance on the internal auditor's work based on the evaluation conducted by external auditors in respect to work performance, competence, and objectivity, which are indicators for the quality of the Internal Audit Function (IAF). With external auditors' support and management's concern, the IAF will be effective towards financial performance. The external auditor's trustworthiness on the information for audit is higher if it's collected from internal auditors. Though both auditors' functions are different for a firm, a healthy relationship between both auditors can impact independence in their works.</p>
	<p>Small Firms and Related Party Transaction</p>	<p>The independence of auditors is said to be low in the case of small audit firms, as they can be influenced easily by management and internal party transactions. Hence, many qualified auditors have no interest in being part of small audit firms.</p>
	<p>Corporate Governance, Objectivity, Tenure, Joint-Audit, Non-Audit Fees and other factors influencing Independence</p>	<p>In a joint audit, it is always better to have a continuous rotation of auditors. An auditor's objectivity is determined by their knowledge of accounting policies and their ability to develop their own. Independence in the internal auditors is questioned as they are the employees of the firm, but a clear corporate governance framework can enable independence and objectivity among the internal auditors. Similarly, the Audit Committee (AC) and the Internal Audit Function (IAF) are two important pillars of corporate governance; if there is good interaction between them, the chances of fraud reduction will be high, which will also help in internal control quality, adding to the</p>

		<p>advantage when internal auditors are considered for management training.</p>
	<p>Audit Quality (Accurate Fraud Detection)</p>	<p>Independence among the internal auditors can reduce fraud and likewise increase audit quality, whereas work stress is one of the parameters that can affect the audit quality. Therefore, fraud detection is more likely to be effective when carried out independently by internal auditors. And when there is no gap between the executive's and internal auditor's communication, the quality of auditing will hold up well.</p>
<p>Association between Audit, Auditor's Independence and Financial Performance</p>	<p>Roles, Competency, Fees, Firm Size and Earnings Management affecting Financial Performance</p>	<p>Internal audit is one of the best functions for government undertakings as their main function is cost cutting, and internal auditors control over financial information, independence in audit, getting normal fees, and so on can impact positive financial performance.</p>

	Corporate Governance and Audit Committee	The audit committee (AC) can help in the proper handling of legal issues related to auditing and can control over internal auditors. AC includes independent members, it is one of the key departments in a firm with more power than management. There is a positive relationship between the audit committee's size, independence, expertise and financial performance, but a few other characteristics of the committee can negatively impact financial performance.
	Internal Control System (ICS)	An effective internal control system will have a good impact on financial performance (FP) when internal auditors supervise the ICS.
	Audit Quality and Effective Financial Management	Audit quality is ensured when there is independence, which is believed to be achieved only by the Big 4 firms, with the audit team being frequently changed, having normal fees, no non-audit service, and so on. Internal auditor independence combined with management support will result in Audit Quality (AQ) and good FP.

## DISCUSSION

### Internal Auditors

Audit and corporate governance's importance was raised as and when the financial crisis took place (University, 2014). Internal audit department is indeed an extra cost to the company (Saidin, 2014), but with well-established characteristics of the audit committee company can derive quality auditing from internal auditors (Abdulaziz Alzeban, 2015), (Razimah Abdullah, 2018), (Elias Gebrayel, 2018). If the internal auditors are performing at high quality, it is said that external auditors will depend on them (Halil Painoa, 2015) (Julie Petherbridge, 2015), with helpful steps taken to guide each type of auditors process (David Breger, 2020) (Hazami-Ammar, 2019), based on work performance, competence and objectivity (Renu Desai, 2017). The judgment by both internal and external type of auditors has similar ability on fraud risk assessment but do vary on client motives, as client's character is understood by internal auditors more comparatively (Zuraidah Mohd-Sanusi, 2015) (Kirsten Fanning, 2014), hence most of the past researchers have

taken the side of internal audit and internal control when it comes to the prevention and detection of fraud (Rohana Othmana, 2015). In case of external auditors' role on fraud risk assessment, it is better to have auditors' rotation, if its joint auditors and if auditor is in long geographical distance (Yangyang Chen, 2016) (Abhijeet Singh, 2019) (Reiner Quick, 2018), but the constraint of distance can be invalid when most of the audit function is through IT (Aidi Ahmi, 2014) (He Lia, 2018).

The internal audit function is not used as the competition platform to train the management, if it is used so, then management will highly influence internal auditors while reporting issues (Florian Hoos, 2018). The management recommendations are considered in the audit function and the management uses audit functional requirement as a benchmark, hence relationship between the auditors and auditee are inclined by management (Sarens, 2017).

The Institute of Internal Auditors (IIA) understand the difficulties on application of required skills by the employees for internal audit as it involves high cost of training, therefore currently, Institute of Internal Auditors allows companies to outsource the internal audit function (Dije Muhammad Suleimana, 2014), there are studies contrasting this, that internal audit service should not be outsourced it will reduce the independency due to the existing threat of losing the contract or reduction in the fees etc. (Roger Meuwissen, 2019).

### **Independence in the auditors (internal auditors)**

The internal auditors usually assume themselves as independent, whereas the independence of the internal auditor is evaluated by the independent external auditor (Ward & Robertson, 1980), (Renu Desai, 2017). The higher the interaction between internal and external auditors, it will show a good level of independence in auditing (Grace Mubako, 2019), also the level of relationship between internal auditors and audit executive will affect the level of independence (Alzeban, 2015). Independence is more important for the Internal Audit to show the appropriate growth towards a company's financial performance (Hamza Mohammad Alqudah, 2019). As per behavioural theory, interaction between audit committee and Internal Audit Function (IAF) will enable chief audit executive to boldly report the frauds irrespective of threats from the management (Imen KHELI, 2016). Internal auditors usually hesitate to report financial frauds to management in order to please them, the independence is lost when such relationship exists, when the audit committee is a watchdog the chances of such relationship might reduce (LAWRENCE J. ABBOTT, 2016). Fraud detection will be better if it is investigated by IAF (Internal Audit Function) rather than other department or management and the CAE (Chief Audit Executive) should ensure independence in the IAF to prove reliability in the function (Hazami-Ammar, Internal auditors' perceptions of the function's ability to investigate fraud, 2019), and also internal auditors recruited for management training ground can practically increase the ability of audit function (Joseph V. Carcello, 2018).

As stated in Economic Theory of Auditors' Independence, there is lack of independency in the work of external auditor when there is quasi-rent (Abhijeet Singh, 2019), (ANTONIO LOPO

MARTINEZ, 2017); auditors size and clients recognition are usually considered as main criteria for the audit quality, many ignore the independence of auditors while evaluating the audit quality. Political influence on the external auditors' works for those firms that are related to the political party (usually audited by big 4 firms), can weaken the independence of auditors (Ahsan Habib, 2017). Auditor specialization and other various psychological factors are influencing the auditors' independence (Iman Sarwoko, 2014), (Huanmin Yan, 2016), (Alzoubi, 2017).

Importance of internal audit function is being encouraged by CG over past 20 years and recently steps taken to make auditors' independency mandatory (Florin DOBRE, 2013), (Milica Đorđević, 2017), CG features have very important part in enhancing the quality of internal audit (Geoffrey D. Bartlett, 2017); such as audit committee and executives, which will be top hierarchy to the internal auditors to ensure independency and objectivity (Milica Đorđević, 2017), (Ahmed Atef Oussii, 2018). There is absence of equality in the information obtained by the outsider and insider of the company, hence it is very important to disclose the internal control audit report (Ye Sun, 2012).

### **Association between audit, auditors' independence and financial performance**

There is a direct and indirect effect of internal audit on financial performance. The companies must concentrate on the principles of accounting; hence it is necessary to include a permanent audit unit in the company to avoid various legal issues (Küçükçolak & Özer, 2007). Internal auditors do stabilize various roles and are considered to be expertise and skilled employees of an organization (Jagongo, 2017). The role of internal audit is most important as it assist in effective application of financial resources as internal audit has a clear knowledge on waste, inefficiencies, frauds, errors etc., internal audit not only utilizes the financial resources but also makes an effort to increase operational activities which will result in positive financial performance and efficiently improve the operations, cost cutting methods, and overall financial management (Aikins, 2011). Internal auditors have various functions and activities that impact financial performance (Mafiana, 2013). The financial performance of a company is impacted positively by the audit quality (AQ), but when the relationship between AQ and FP is controlled by Product Market Competition, then high competition leads AQ to positively impact FP and Vice Versa (Usman Sattar, 2020). It is said high quality of audit is encountered in large firms and not small firms (Mariana Nedelcu (Bunea), 2015), (David Okelue Ugwunta, 2018).

The audit quality and its effectiveness on financial management is ensured when management allows independence to the internal auditors (Desmond Ziniyel, 2018). The internal auditor must have independence to overview each functional department to rectify the error, and can give this overview report to the external auditor (Gal, 2017). The external auditor is the guarantee for the financial statement to the stakeholders whereas the internal auditor is the guarantee for the financial information to the external auditor (Alzoubi, 2017). Auditor's independence will be lacking if the auditors are favourable to the clients (Florin DOBRE, 2013), strict guidelines on the auditing and

ensuring transparency in the firm's financial information presented to public, there will be no question raised against the trusting of financial information's (Abdullahi Bala Ado, 2020).

A firm that holds on to corporate governance and has a good structure of internal system is said to have a positive overall performance (Haiyan Zhou, 2018). CG likewise has made way for quality audit under the guidance of the audit committee (Vasile Dinu, 2015). Having many members in the audit committee usually will have good comparability with financial statement, expertise auditors in the audit committee are very essential for quality tracking of financial performance (Medhat Endrawes, 2018), (Mohammad Mustafa Dakhlallah, 2020), (Alqatamin, 2018)

## CONCLUSION AND SUGGESTIONS

Systematic review was conducted on the Independent Internal Auditors, which is one of the prominent research areas to focus in accounting currently, using relevant keywords related to the research question that is independence among the internal auditors. The quality of the selected literatures was assessed as per WoE Framework (Table 4), following which the synthesis of literatures was written thematically in order to integrate the various findings under each category, to present the objective of systematically reviewing the studies and covering various factors of internal auditors. There is less clarity and unexplored factors on internal auditors from the past researches, as we have already seen internal auditors are the backbone of internal structure of an organization, if independence is ensured in the internal audit function and if organizations strictly follow corporate governance, it will make a way for an organization to grow financially (Jan Svanberga, 2018). Internal auditing plays a significant role in a company and provides monetary benefits; this is an area that future studies need to explore in detail by highlighting the importance of internal audit function and its impact on a firm's financial performance. An investment in a strong piece of business can give a better return.

Most of the research on the audit quality and its relationship with financial performance is based on the audit firm size and client's recognition and the fact of independent internal auditor is ignored majorly (Booker, 2018). Future researches on internal auditors should focus on restriction level of auditors that is likely to affect the auditors' independence (Gal, 2017), the importance of proper certified auditors in internal audit department and relationship of long-term audit with independency (Florin DOBRE, 2013). Type of client's business and policies; internal auditors and company's performance between family and non-family firms (Alqatamin, 2018) are another important factor that will affect independence. The independent auditors' impact on financial performance can be studied by comparing it with categories of industries.

Psychological behaviour of internal auditors on negative perceptions towards their profession; stress level (Huanmin Yan, 2016), and adverse perception of internal auditors on their profession (Geoffrey D. Bartlett, 2017) are new area of research. The external auditor's reliance for data while conducting annual audit is mostly concentrated on internal audit department, but external auditors' reliance on other functions of the company is ignored.

Variables such as gender of internal auditors; social, cultural and economic dynamics of internal auditors can be included to study the internal auditors' impact on performance. The factors of internal audit like audit committees, audit quality, internal audit executives, confidence, trust and so on are other most important factors for future studies; not just managers but audit executives, external auditors, and the audit committee relationship with internal auditors also impacts independence which need to be explored. Managers response to different auditing contexts, trust issues over long run with various interaction personnel in a firm by internal auditors can also be researched (Ewald Aschauer, 2015). Tax compliance and tax audit role of internal auditors can be made more informative through research. Internal auditors' relationship with other internal department of a firm is widely studied, whereas independent internal auditors that are of interest to investors (Eulerich, 2019), opinion of investors on internal auditors are other viewpoint of internal auditors' role, which can be analysed in future.

The question of “does independence exist among local auditors and does the long-term auditors lack independence?” is not clearly answered yet, the future research should focus on unlisted firms or small firms or non-big 4 firms' impact from internal audit function and their independence affecting financial performance including more narrowed factors of independence and financial performance like capital adequacy of credit risk, market risk, operational risk; most of the study included only a few indicators that measure the performance, future research can include other indicators such as capital adequacy of credit risk, market risk, operational risk, etc (Mariana Nedelcu (Bunea), 2015). Separate corporate governance framework for small firms is another broad area to be researched, which will encourage small firms to have an internal audit department. The role of internal audit in the government firms and their impact on overall government financial performance can be studied vastly. Qualitative research on various measures of fraud prevention by internal auditors can be conducted, in such a way it is framed as a qualitative model and can initiate proposal towards corporate governance framework.

Most of the studies include data which is geographically limited, there is no study concluding the findings globally. The financial performance a quantitative aspect is affected by internal auditing characteristics, which need to be more clearly explored with proper analytical and case evidence; all the studies reviewed are concentrating only on one methodology, further studies can investigate the impact of internal auditors using mixed-method methodology. If further studies can build independence framework that describes the qualitative characteristics of independent internal auditors (Ward & Robertson, 1980), it will be a great contribution for researchers to understand on the internal auditor's independence.

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