

RESEARCH NOTE

#PARG 2020-09RN

Factors that may challenge the quality of internal audit in the Canadian Federal Government

Ouafa Sakka, PhD February 2020

At the turn of the 21st century, and in reaction to one of the most mediatized scandals in the public sector in Canada, i.e. the sponsorship program scandal (Neu, Everett and Rahaman, 2013), the federal Government of Canada adopted several policies in order to strengthen oversight of public resources. One of the most important policies adopted in 2006 was the Policy on Internal Audit that aimed to better structure and to strengthen the position of internal audit functions (IAF) in the government's departments and agencies. The main requirements of the policy (TBS, 2006) were that:

- (i) public departments put in place an IAF that is responsible of providing deputy ministers with independent assurance and advice,
- (ii) IAFs report functionally to an independent departmental audit committee composed in majority of external members recruited from outside the federal government,
- (iii) IAFs report administratively to the deputy minister, and
- (iv) internal audit findings be published on a public platform for more transparency.

The Treasury Board of Canada Secretariat (TBS) policies were based on the standards and frameworks of the Institute of Internal Auditors (IIA), an international professional association that provides organizations in both the private and the public sector with normative and methodological guidance about internal audit. Despite of the bold measures adopted by the Canadian government, recent research publications and reports available from the IIA show that there is still room to improve the value delivered by IAFs in the Canadian public sector (Roussy, 2013) and more specifically in the federal Government (Abela and Mitchell, 2014; Juillet, 2016).











The objective of this research is to determine the factors that may challenge the quality of internal audit in the Canadian federal government, based on concepts and findings from the accounting literature, the literature in public policy and administration, the internal audit (IA) professional literature and the Canadian federal government policies on internal audit.

Quality of internal audit

The first step in discussing the factors that challenge the quality of internal audit in the federal public sector is the definition of the 'IA quality' concept. Previous research suggests that internal auditors and audit committee members define IAF quality by referring to the *output* of the IA process, i.e. internal audit reports and advice services, which should be useful to the organization's top management. The Institute of Internal Auditors (IIA) defines quality primarily by focusing on the audit process which should conform with the internal audit standards and best practices (Roussy and Brivot, 2016). Other researchers refer to the *input* to the audit process and define IAF quality based on internal auditors' competence (years of experience, education, training, certification, communication skills), independence (whether or not the IAF reports to an audit committee), and the budget allocated to the IAF (Abbott, Parker and Peters, 2012; Mihret, James and Mula, 2010; Pizzini, Lin and Ziegenfuss, 2015). In the present research, we consider IAF quality as a multidimensional construct, which refers to the input, process and output of the internal audit and we consider that these three dimensions are inter-related. Hence, when discussing the factors challenging the guality of IAF, we consider all factors that may hinder the competence of the internal auditors. their independence, the conformity of the audit process to the audit standards and the usefulness of the audit outputs to the s management.

Based on a comprehensive review of the academic and professional literatures on internal audit and public sector administration, this research classifies the factors that challenge the quality of the IAF in three categories: (i) factors inherent to the day-to-day work of internal auditors, (ii) factor related to the profession of internal audit in the public sector, and (iii) factors related to the context of the Canadian federal sector. These factors are discussed below.

Factors inherent to the day-to-day work of internal auditors

The accounting literature on internal audit provides evidence that internal auditors face several conflicts and threats to independence in their day-to-day work. First, internal auditors are expected to play two main roles in organizations, namely: assurance and advice. While the assurance role requires the auditor to be independent from the auditees including top management, advisory activities require the opposite as the auditor should understand top management's needs and objectives to be able to offer advice on how to best achieve them. This situation may give rise to an *inter-role conflict*. According to Roussy (2015), internal auditors in the Government of Québec cope with this conflict by accepting the idea that executives are their real bosses and that they

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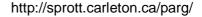
should satisfy their needs, sometimes at the expense of their independence. Given the different legislation in the federal sector, it would be interesting to study whether the same coping strategies are used by internal auditors when facing inter-role conflicts.

Second, internal auditors in the federal public sector report administratively to the top manager but functionally to an independent audit committee (AC). While both management and ACs should work on achieving the organization's objectives and managing the strategic risks, the AC is an oversight mechanism that may decide to challenge the management. In such case, internal auditors may experience an *intersender conflict* due to the conflict in the expectations of different role senders. While the requirement to report to an independent AC is expected to strengthen the position of the internal audit function and enhance its independence, existing research provides mixed results. Some authors report that an independent AC that has financial expertise and interacts frequently with the Chief Audit Executive (CAE) helps the IAF to be most effective (Goodwin, 2003), but others find that when reporting directly to an AC, internal auditors decrease their assessment of risk or try to reveal only the results that were previously approved by top management (Norman, Rose and Rose, 2010; Roussy, 2015).

Therefore, reporting to an independent AC may be counterproductive and become a threat to the independence and objectivity of the IAF. In the Canadian federal sector, some evidence available from the professional literature suggests that ACs are perceived as lacking the required skills to advise IAFs because they are hired from outside the federal sector (reference). More research is required to understand the relationship between IAFs and ACs in the federal sector, whether ACs challenge deputy ministers and internal auditors and how internal auditors cope with inter-sender conflicts when they occur.

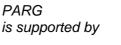
Factors related to the profession of internal audit in the public sector

Internal auditors in the Canadian federal sector are required to follow the standards set by the Institute of Internal auditors (IIA), a global professional body that regulates the practice of internal auditing worldwide and in all sectors of the economy (Rylska, 2018). Chief audit executives are also expected to obtain their Certification in Internal Audit (CIA) granted by this same institute before or during their appointment. This is an implicit recognition by the Canadian Government that internal audit is a 'profession' with a separate set of expertise that can be relied on. However, both academics and professionals recognize that internal auditing is currently at crossroads (Lenz and Hahn, 2015, Price Waterhouse Coopers, 2013) because it is facing several challenges including the need to acquire new sets of skills such as data analytics, and the increased demand of diversified services that add value beyond assurance missions. According to Arena and Jeppesen (2010), developments in the internal audit profession lagged developments in external auditing as internal audit is still a self-regulated profession that is not mandated or legislated.











The legitimacy of the internal audit profession is due in part to exogenous factors such as the financial scandals in both the private and public sectors throughout the world and the development in theory and state regulations, which gave paramount importance to strategic risk management, sound internal controls and proactive internal audit as key determinants of good governance. In response to the changes in the internal audit demand and the increased need of organization executives for advice in strategic risk management matters, the IIA implemented several changes to its frameworks and guidelines. In addition, the definition of internal audit evolved from an assurance activity that deals mainly with accounting and financial matters (definition in 1974) to an assurance and consulting activity expected to add value to the organization (definition updated in 1999). These changes gave rise to a new IA paradigm focused on valueadding. The Government of Canada (with Australia and UK) was among the early adopters of the value-added paradigm of Internal audit in early 2000 (Bouckaert, 2008). At that time, IIA guidance and best practices were based on its accumulated knowledge of the IA practice in the private sector since its inception in 1941. It is only in 2010 that the IIA set a Public Sector Guidance Committee, which resulted in publishing specific guidelines for internal audit in the public sector.

In summary, the value-added internal audit paradigm is practice-driven and was developed by IIA to satisfy the needs of improved governance and risk management by the private sector. Its adoption by the government of Canada and other countries without questioning its value for the public sector may be problematic. So far, there is no comprehensive research about the outcomes of this adoption and whether or not there were any issues with its implementation (Rylska, 2018 is a recent exception).

Factors related to the context of the federal public sector

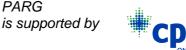
Operating in the specific context of the federal public sector adds to the challenges encountered by internal auditors. Heintzman (2018) states that the culture in the public sector, which has a mandate to support elected ministers in implementing their objectives, may promote self-censoring and inhibit professional judgment and innovation. Such organizational culture can work against internal auditors' ability to add value as their main task is to find issues and help fixing them.

In addition, Chief Audit Executives (CAEs) report to deputy ministers who have to supervise the implementation of numerous policies and programs as well as report to the Minister and several other parties in the government, and hence have extremely busy schedules. This requires that CAEs be very concise and precise in their communications in order to be 'useful' to the deputy ministers. Based on evidence collected from Canadian public servants including in the federal sector, Abela and Mitchell (2014) find that senior executives perceive that there is a relative lack of public sector administration knowledge among internal auditors, that their focus on compliance and financial management is sometimes exaggerated, and that many CAEs lack the senior-level experience, which all hinder IAF capacity to provide foresight and proactive advice about strategic risks.

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Despite the anecdotal evidence that exists about the challenges related to operating in the federal public sector, there is no comprehensive academic research that analyzes how these factors are perceived and managed by internal auditors, how IIA is integrating them in its guidance for public sector auditing and whether government policy makers are trying to take them in account when developing policies.

Contributions

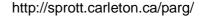
This research is proposed at a time when the Canadian federal government is facing mounting pressure to use public resources in a responsible manner, to be more transparent and to innovate in its practices (Abela and Mitchell, 2014). The Government Policy on Internal audit, introduced in 2006, expects public internal auditors to play an important role in assisting public servants with managing strategic risks and preventing governance issues through providing assurance and advice services. However, the Internal Audit profession is challenged to prove its added value to organizations in general (Mutchler, 2003; Lenz and Hahn, 2015), and to organizations in the public sector in particular. Internal audit is a practice-driven discipline, based mainly on satisfying the needs of the private sector and has no clear theoretical foundation that justifies its usefulness to the public sector.

Although there has been some research about the issues encountered by internal auditors in their day-to-day work, most of it is based on evidence from the private sector and none of the existing studies considers discussing the challenges to internal auditors in the specific context of the federal sector in a comprehensive manner. The knowledge created by this research will be useful to a wide range of stakeholders. First, researchers in accounting and public sector administration will benefit from a comprehensive analysis of the factors that challenge IAF quality in the federal sector and are encouraged to further investigate the impact on the quality of IA in future research. Second, this research provides insights to policy makers and IA standard setters about the issues that they should consider when writing future policies and IA standards in the specific context of public sector. Third, the analysis of this research from a perspective of professions' evolution (Abbott, 1991) will also provide the basis for discussing the next change that should occur in the IA profession if it is to prove its added value to the public sector.

ABOUT THE AUTHOR

Ouafa Sakka, PhD, is an Associate professor in the Sprott School of Business, Carleton University and member of the Sprott Centre for Social Enterprises / Centre Sprott pour les entreprises sociales (SCSE/CSES) and of the Professional Accounting Research Group (PARG).

ouafa.sakka@carleton.ca













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