Internal Control Environment and Ethical Values of Internal Auditors

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Abstract

To enhance corporate governance practices the Naresh Chandra Committee emphasized auditor objectivity, independence and faithful representation. The Institute of Internal Auditors (2004) defines Internal Audit as an "Independent, objective assurance and consulting activity designed to add value and improve an organization's operations". It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate. Several researches have attempted to find out the drivers and factors that influence auditor independence and objectivity from diverse points of view. The present study aims to examine internal auditing in the context of Control Environment using the COSO framework. Data was collected using a structured questionnaire from 80 respondents (auditors and accountants from 10 companies). Results are indicative of an overall mean score of control environment is 74.2 % which denotes a fairly ethical control environment of auditing. Looking at the components there appears to be clarity with respect to reporting lines and the auditors and the superiors are accountable for their work. Superiors share responsibility of following the ethical code and they themselves are held accountable in case lapses occur. There is clarity, transparency and acceptance of lines of communication and reporting; which leads to a favourable control environment. Leadership is overall committed to implementation of the code of ethics.

Keywords: Internal Auditors, Ethical Values, Internal Control Environment.

Introduction

The Indian regulatory establishments in a bid to enhance good governance practices in the national context and to protect the investor and other stakeholders appointed the Naresh Chandra Committee to examine various corporate governance issues by the Department of Company Affairs on 21 August, 2002. The Committee report emphasized auditor objectivity, independence and faithful representation.

The Institute of Internal Auditors (2004) defines Internal Audit as an "Independent, objective assurance and consulting activity designed to add value and improve an organization's operations". It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate. Thareja (2015) asserts that independent internal auditing is very important in the objective assessment of systems and existing architecture of the firm. At present a select class of companies in India is mandated to put in place an Internal auditing function. Again, Thareja (2015) states that 'the scope of an internal audit has not been statutorily defined by any of the laws in India', but it may be noted that companies are increasingly recognizing and embracing the need for an internal audit function for proper corporate governance. In fact, every company whose shares are listed is required to have an internal auditing system in place.

Several researches have attempted to find out the drivers and factors that influence auditor independence and objectivity from diverse points of view; while some scholars study external auditor independence and objectivity, other studies consider independence and objectivity in the context of internal auditors,; however whether it is internal or external auditors Cecil (2017) pointed out that such studies have measured auditor independence and objectivity with the help of developed scales and the Internal Audit code of ethics. It was further argued that auditor objectivity and independence transcends beyond merely written codes of ethics and there maybe other unwritten codes which are value laden and inherent in nature.

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Review of Literature

The presence of an ethical code of conduct with stringent enforcement policies can enhance ethical behaviour in an organizational context [Sim,& Keon (1999), Weaver & Ferrell (1997), Peterson (2002), Hanson & Fleischman (2018)] similarly, Greenberg (2002) indicated that individuals who work in an office that has established ethics program are less likely to engage in unethical behaviour than otherwise. Pflugrath (2007) and Schwartz (2001), reported that the presence of code of ethics has a positive impact on the quality of the judgements made by professional accountants, although not on students. Booth and Schulz (2004), indicated that a strong ethical environment will be effective in reducing the tendency for managers behaving unethically.

Glenn & Loo (1993) reported that although code of ethics to some extent influences ethical behaviour, such an influence is not as strong as the influence that personal value system has on ethical behaviour. Simga et al (2005) found that people with a higher sense of professional values are more ethically sensitive than others; and ethical relativism is negatively related with ethical sensitivity (Svanberg & Ohman, 2013). Moral intensity significantly predicts ethical sensitivity Shapeero et al (2003); Individuals who are idealistic contributed significantly to judgements of moral concern (Simga, et al., 1999). Instrumental values have a greater impact on ethical judgement than terminal values (Ross et. al., 2000) and individuals with high idealism or less relativism tend to make stricter ethical judgements (Kim, 2003).

Objective of the Study

The present study aims to find out the internal control environment with respect to ethical values of internal auditors

Research Methodology

To assess the control environment of businesses, the COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework was used. The COSO framework, that to ensure organizations effective and efficient functioning, there is a need for appropriate internal auditing practices and activities to be instituted. Moreover, the framework provides that internal auditing and control practices should not be considered as a standalone or just one solitary activity, but as a series of activities in a system-wide manner. The COSO framework provides five major components of internal controls namely, risk assessment, control environment, control activities, information and communication and monitoring.

Table 1 depicts the Control Environment component of COSO framework.

Table 1: Components of Control Environment of COSO framework

Control Environment
1. Commitment to integrity and ethical values.
2. Independent board of Directors' oversight
3. Structures, reporting lines, authorities and responsibilities
4. Attract, develop and retain competent people
5. People held accountable for internal control

Using the above framework, the control environment was assessed. Ten companies were purposively selected and from each company, internal auditors and accountants were selected as respondents. A total of 80 respondents participated in the study. Data was collected by a semi structured interview. Each interview was then transcribed and a two level content analysis was carried out.

Results & Discussion

The Control environment is the organizational structure and culture created by management and employees to sustain organizational support for effective internal control. When designing, evaluating or modifying the organizational structure, management must demonstrate its commitment to competence in the workplace (Tarantino, 2006). The COSO framework asserts that managements attitude towards internal controls reflects their philosophy in that regard. The extent to which management demonstrates a commitment to integrity and ethical values, accountability, human resource management, independent board structure among others, is an indication of their commitment to internal controls. Table 2 depicts the responses of selected participants with respect to the various components of control environment.

Table 2: Responses to various Components of Control Environment

S.No.	Component of Control Environment	Yes %	No %
1.	**Commitment to ethical values and Integrity**		
	Ethics are formalized into corporate codes	78	12
	Ethics is a part of leadership agenda	67	23
	Superiors show exemplary behaviour with respect to ethical values and integrity	63	37
2.	**Governance Board, Reporting Lines & Accountability**		
	Board is independent	87	13
	Board is ethical	63	27
	Board members are usually from the same family	91	09
	Balance between executive and non-executive board members	90	10
3.	**Structure and Reporting Lines, Accountability**		
	Reporting Lines clearly laid down and are transparent	92	08
	Reporting lines complied with most of the times	94	06
	Subordinates may also demand accountability from superiors	76	24
	Conflicting roles in reporting lines	20	80

4	**Attract, develop and retain competent people**		
	Selection of internal auditors strictly after checking ethical stance	42	58
	Firms hold training and orientation programs to ensure clarity on ethical behaviour and ethical code	78	22
	Recognition given to competent internal auditors who follow ethical code	82	18
5.	**People are held accountable for internal control**		
	Superiors usually held accountable although internal auditors follow their instructions	85	15
	Superiors share responsibility of following ethical code	86	14
	Internal auditors try to shift accountability to external auditors	72	28

Source: Survey 2019 by Researcher

Above data shows that 78% of the respondents reported that ethics are formalized into corporate codes in order to enhance its enforcement and 67 % said that ethics is a part of the leadership agenda to show more compliance to rules and regulations. In keeping with this 63 % felt that leaders exhibited ethical behaviour and integrity so that they could set an example on the employees.

Further more, 87 % reported that the Board was independent and 63 % said that it was ethical too. It was also reported by 90 % that a balance between executive and non-executive board members was maintained, while 91 % insisted that the Board comprised of members from the same family, by and large.

As far as the reporting lines and accountability is concerned 92 % maintained that reporting and communication lines were clearly laid down and 94 % confirmed that these lines were complied with most of the times. Only 20 % said that reporting lines tended to be conflicting at times. An interesting finding was that 76 % of the respondents revealed that subordinated also were in a position to demand accountability from superiors.

Data revealed that it was not possible to find out the ethical stance of the internal auditors before selecting them (42 % respondents); but due recognition was given to competent internal auditors who follow ethical code (82 % respondents). In an effort to ensure ethical integrity firms hold training and orientation programs reported 78 % of the respondents.

85 % of the respondents confirmed that superiors usually were held accountable although internal auditors follow their instructions only and 72 % reported that internal auditors try to shift their accountability to external auditors, in an attempt to shift accountability.

Table 3 depicts the mean scores for each component of control environment of COSO framework in the context of selected companies.

Table 3: Mean Score for each Component of Control environment.

S.No.	Component of Control Environment	Yes %	No %
1.	Commitment to ethical values and Integrity	69	31
2.	Governance Board, Reporting Lines & Accountability	83	17
3.	Structure and Reporting Lines, Accountability	71	29
4	Attract, develop and retain competent people	67	33
5.	People are held accountable for internal control	81	19

Conclusion

The overall mean score of control environment is 74.2 % which denotes a fairly ethical control environment of auditing. Looking at the components there appears to be clarity with respect to reporting lines and the auditors and the superiors are accountable for their work. Superiors share responsibility of following the ethical code and they themselves are held accountable in case lapses occur. There is clarity, transparency and acceptance of lines of communication and reporting; which leads to a favourable control environment. Leadership is overall committed to implementation of the code of ethics.

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