

CHAPTER TWO

REVIEW OF LITERATURE

This chapter reviews the theories and concepts, and the related research studies in four main areas: (1) the roles of an internal auditor, (2) the theoretical aspects of various communication skills, (3) effective audit communication opportunities, and (4) the phases of internal audit process.

2.1 THE ROLES OF AN INTERNAL AUDITOR

There has been a great deal of diversity among the roles of internal auditors in organizations, even within the same industry; therefore, the Institute of Internal Auditor [IIA] first issued a Statement of Responsibilities of Internal Auditing in 1947, and has updated it continually. The International Standards for the Professional Practice of Internal Auditing issued by IIA (2004) stated that:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. (p. 1)

Internal auditing involves at least four activities: assuring, consulting, evaluating, and improving. Although internal audit activities are diverse among organizations that vary in purpose, type, size, and structure, the generally accepted roles of the internal auditors in each environment are not much different from the Standards.

According to the Standards (IIA, 2004), assurance services generally involve three parties within the organizations:

- (1) The process owner: the person or group directly involved with the process, system or other subject matters.
- (2) The internal auditor: the person or group making the assessment.
- (3) The user: the person or group using the assessment.

In addition, consulting services generally involve two parties:

- (1) The internal auditor: the person or group offering the advice.
- (2) The engagement client: the person or group seeking and receiving the advice.

If both assurance and consulting activities have been performed, the internal auditors need to communicate with at least three parties, including the process owner, the user, and the engagement client. In addition, if they are not the only internal auditor in the organization, they also have to communicate with other internal auditors.

However, the roles of internal auditors in communications according to the Performance Standards, as a part of the Standards (IIA, 2004), do not emphasize communications with the process owner, but are obviously indicated as follows:

Firstly, to effectively manage the internal audit activities, the Chief Audit Executive (CAE) should communicate the internal audit activity's plans and resource requirements to senior management and to the board for review and approval. CAE should also share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts. In addition, CAE should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan.

Secondly, internal auditors should communicate the engagement results, including the engagement's objectives and scope, conclusions, recommendations, and action plans. Final communication of engagement results should contain the internal auditor's overall opinion and conclusion. Moreover, when releasing engagement results to parties outside the organization, the communication should include limitations on distribution and use of the results. For consulting engagements, communication of the progress and results will vary in form and content depending upon the nature of the engagement and the needs of the client.

Thirdly, the Chief Audit Executive should communicate results to the parties who can ensure that the results are given due consideration. CAE are also responsible for communicating the final results of consulting engagements to clients, and whenever risk management, control, and governance issues are significant to the organization, they should be communicated to senior management and the board.

Finally, communications should be accurate, objective, clear, concise, constructive, complete, and timely, and if a final communication contains a significant error or omission, the Chief Audit Executive should communicate corrected information to all parties who received the original communication.

In addition to senior management and the board, clients, appropriate parties to be given the results, or other assurance and consulting service providers, the chief audit executive and internal auditors are required to communicate with the process owner, which normally consists of management, supervisors, and officers or staff operating a particular process. However, as mentioned above, the Standards do not emphasize this party.

According to the Performance Standards, the role of internal auditors as a communicator is mostly limited to the role of a message sender only, but actually they are also a message receiver, especially as a listener. The word ‘audit’ is derived from Latin ‘auditus’ meaning ‘hearing’. Sawyer (1996) has said that audit has a long and noble history: “Ancient Rome ‘hearing of accounts’ one official compares records with another – oral verification gave rise to the term ‘audit’ from the Latin ‘auditus’ – a hearing”. At the beginning of any assurance or consulting engagements, the internal auditors need to listen to the requirements of the board and senior management or the engagement clients, need to liaise with other internal audit team members, and need to gather information about the process, system, or other subject matters by interviewing or discussing with the process owner in order to analyze, evaluate, and conclude their opinions on that information. Consequently, they have to play many roles of communicators to complete their engagements.

2.2 THE THEORETICAL ASPECTS OF VARIOUS COMMUNICATION SKILLS

Communication involves conveying, translating, receiving, and acknowledging the message via a medium. Krietner (2004) describes communication as a chain made of identifiable links, including sender, encoding, medium, decoding, receiver, and feedback. The sender is an individual or a group of people who convey or transmit the message to a receiver in the best possible media and in the fastest way. Encoding is translating internal thought patterns into a language or code that the

intended receiver of the message will be able to understand. Medium is a vehicle to send or receive a message. There are many types of media, such as face-to-face communications, telephone calls, regular meetings, video conferencing, memos, letters, reports, facsimiles, and others. Decoding is the translation of the transmitted message from the sender's language and terminology to the receiver's. The receiver is an individual or a group of people who acknowledge and receive the intended message sent by a sender. The communication process is not complete until the receiver acknowledges the message via verbal or nonverbal feedback to the sender. Consequently, Vallabhaneni (2005) defines methods of communication as listening, writing, and speaking.

There are many barriers that block effective communications, including diminishing of self-respect in others, triggering defensiveness, resistance, and resentment. These can lead to dependency, withdrawal, and feelings of defeat or of inadequacy (Vallabhaneni, 2005). Bolton (1979) presents the following three major categories of roadblocks:

1. Judging: Judging, the major roadblock for effective communication, involves approving or disapproving of the statements of the other person. There are five aspects of judging as follows:

- 1.1 Criticizing: This is a way of life of some people. Many of them feel they ought to be critical, otherwise people will never improve.

- 1.2 Name-calling and labeling: These have negative overtones to both the sender and receiver. This is because labeling prevents them from getting to know other individuals and themselves.

- 1.3 Diagnosing: This is a form of labeling and occurs when the listener does not listen to the substance of what a person is saying, or plays emotional detective, probing for hidden motives, and the like.

- 1.4 Praising: Praising, or expressing positive feelings toward people, is an important element of interpersonal communication.

- 1.5 Finger-pointing: Pointing the finger at others does not improve communication or relationships.

2. Sending solutions: Sending solutions to others can be risky because the person receiving the solution can misinterpret or misread the solution as the following aspects:

2.1 Ordering or bossing: An order is a solution sent coercively and backed by force. Coercion leads to resistance and resentment.

2.2 Threatening: A threat is sent with an emphasis on the punishment that will be forthcoming if the solution is not implemented.

2.3 Moralizing: This fosters anxiety and invites pretense.

2.4 Advising: This can be interpreted as a basic insult to the intelligence of others. Some people give advice inappropriately and do not understand the full implications of the problem.

2.5 Excessive questioning: This often details a conversation. Indirect or incomplete questions can breed defense reactions and resistance.

3. Avoiding the other's concerns: This can be divided into three aspects:

3.1 Diverting: Some people divert a conversation because they cannot listen effectively or want attention from the speaker. Others divert the conversation to a topic more comfortable for them. When another person is under stress or when there is a conflict between people, there is no place for logical solutions.

3.2 Logical argument: Logic focuses on facts, but the stressed person likes to address his feelings, and the two do not fit.

3.3 Reassuring: Reassurance can drive a wedge between people. It is a way of seeming to comfort another person while actually doing the opposite. It can be a form of emotional withdrawal.

Due to above-mentioned barriers, Bolton (1979) describes three essentials for effective communication: genuineness – being honest and open about one's feelings, needs, and ideas; non-possessive love – accepting, respecting, and supporting another person in freeing way; and empathy – the ability to see and hear another person and understand him from his perspective. The person who has mastered the skills of communication but lacks genuineness, non-possessive love, and empathy will find his expertise irrelevant or even harmful. There is more than one way to express such attitudes. The more a person develops his communication skills, the greater the number of constructive alternatives that become available to him. As

some people develop these three skills, they grow into the more communicative person that they can become (Vallabhaneni, 2005).

As an internal auditor has to communicate with several parties, he needs to know all the existing barriers that can block effective communication. The internal auditors should be mindful of all roadblocks, especially of criticism and all aspects of sending solutions because the internal auditor's work can be taken as a criticism of the person that is being audited and the internal auditor's actions might be seen as 'sending solutions'. As far as essentials of communication skills are concerned, genuineness is essential to auditor-auditee relationships (Vallabhaneni, 2005). In addition, non-possessive love is beneficial to the internal auditors because once they accept and respect a person, especially an auditee, he tends to be more at ease around them. Empathy is also important, but the internal auditors need to be careful with it because it can be perceived as excessive if a person identifies very closely with another, and this can affect the internal auditor's integrity and objectivity. The internal auditors should exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined and should make a balanced assessment of all the relevant circumstances and not be unduly influenced by their own interests or by others in forming judgments (IIA, 2004). However, it is reasonable to accept that when the internal auditors practice these three essential communication skills – genuineness, non-possessive love, and empathy, it is much easier to agree or disagree with the auditee about audit findings, values, and other issues (Vallabhaneni, 2005), and the internal auditors will be able to complete their assurance and consulting engagements on a win-win basis.

2.3 EFFECTIVE AUDIT COMMUNICATION OPPORTUNITIES

Moeller and Witt (1999) stated that communications are an important element of every phase of internal audit activities. All internal auditors should understand how to maximize job satisfaction, improve communications, and handle organizational conflicts.

2.3.1 Maximizing Job Satisfaction

Job satisfaction comes first from expected things such as reasonably pleasant working conditions, fair compensation, and qualified supervision. The

second kind of job satisfaction comes from higher levels of self-expression and self-fulfillment, including the assignment of greater job responsibilities, more authority, the opportunity to learn and develop, the opening of broader career opportunities, and being given greater freedom to achieve results without burdensome restrictions.

Participative management can be practiced successfully in connection with all phases of the management process – planning, organizing, providing resources, administering and controlling – especially in connection with making key decisions about goals, policies, and procedures. However, if a participative management effort is perceived by the lower-level subordinates as being superficial, for example, when views submitted are not fairly or adequately considered – the entire managerial approach can do more harm than if never attempted. Other limitations include the need to withhold certain vital information. Internal auditors should keep participative management concepts in mind when making audit recommendations and when organizing their own internal audit organization efforts.

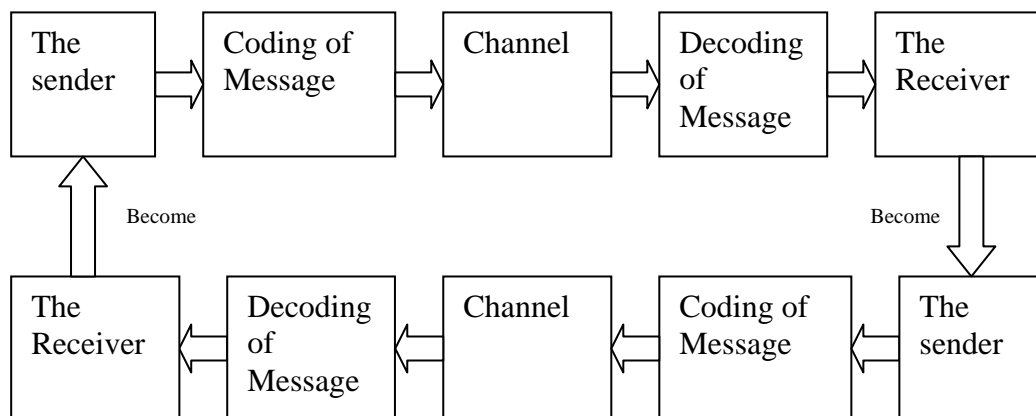
In addition, the establishment of proper standards for rewards and related penalties is an essential part of the management of people. The rules governing those rewards and penalties must be defined, properly interpreted, and administered throughout the organization. Internal auditors need to recognize the importance of these standards in human relations and the need that they be administered in a manner that demonstrates genuine concern and fairness to all participants. Because of the sensitive nature of any human relations system of rewards and penalties and the varying objectivity of individuals in evaluating fairness, there are bound to be differences of opinion and some resulting dissatisfaction surrounding any system. Individuals will tend to judge the system in terms of the impact on themselves, and their criteria will be the fairness of the system as designed and as administered.

2.3.2 Effective Communication

Effective communication both on a person-to-person basis and with larger groups in the organization is a key component to internal audit success. The modern internal auditor should have a good understanding of some of the problems associated with effective communications and an understanding of how to cope with those problems. Situations continuously arise in the operations of an organization

when two individuals need to communicate with each other. These include giving oral instruction to a staff auditor, discussing an operational problem during an audit exit meeting, counseling a subordinate, interviewing a prospective employee, or conducting a staff performance review. All of these situations involve differing personal relationships, but consist of a continuing two-way flow of messages that follows a definable technical model, as shown in Figure 1.

Figure 1. Sender and receiver communication model.



From *Brink's Modern Internal Auditing* (5th ed., p. 24), by R. Moeller, and, H. N. Witt, 1999. New York: John Wiley & Sons.

An internal auditor should understand this process in order to identify the kinds of problems that can distort or actually prevent effective communications. These problems affect all steps in the model, for example:

(1) Not giving proper consideration to the power relationship of sender and receiver. For example, communication with a line supervisor will be different than with a senior officer.

(2) Ignoring temporary emotional stress by either the sender or receiver. For example, an audit exit meeting can often turn into an emotional situation unless the internal auditor takes care to consider potential emotional stress.

(3) Impact of nonverbal actions such as tone of voice, facial expressions, and manner of communication.

(4) Not giving consideration to the perceptions and related feelings of the recipient. Auditors should try to understand how messages will be received and decoded by their receivers.

All of these problems are part of the larger need for an internal auditor to put him or herself in the receiver's perspective and to consider how a message will be received – this is sometimes referred to as 'empathy.' When done with sensitivity and judgment, the result is a foundation for effective two-way conversation. The communicator must do everything practicable to understand how the receiver thinks and feels, and then to communicate in a manner that gives all possible consideration to that knowledge. In addition, both the sender and the receiver learn from the questions and comments made by the receiver in response to a series of messages. This is called 'feedback.' Listening is important to utilize any feedback better and to demonstrate interest in the other person's view. Otherwise, the results can create an emotional response that significantly blocks the receiver's acceptance and understanding of the sender's intended message.

2.3.3 Conflict and Organization Change

People have varying needs that relate alternatively to competition, conflict, and cooperation. Traditionally, conflict has been viewed as destructive and hence undesirable. However, this does not mean that conflict cannot get out of control. Internal auditors need to learn to utilize conflict to the point where it is constructive and to control it when it threatens to get out of hand. To do this effectively depends upon a good understanding of people and a great deal of practical judgment.

Internal audit task and group responsibilities unavoidably generate situations that set the stage for competition and potential conflict. In the course of their review, auditors often find themselves in conflict with various elements of an organization. This can cause auditees to lose a level of competitive standing within their organizations. Auditees may disagree with the audit team on just that basis. The effective auditor should use this conflict to communicate with management and convince it to take appropriate actions. However, the effective auditor needs to understand how to control that conflict.

In the typical organization, there is also a continuing need for properly balancing stabilization and change. On the other hand, management seeks stabilization through developing policies and procedures whereby operations are standardized to improve internal controls and to assure the best handling of recurring

similar types of events. However, changing conditions call for amended policies and procedures. The problem is to find proper balance between stabilization and needed change. This is complicated because the perception and resolution of needed changes are often very difficult and controversial. Changes must be affected by people with the required expertise, adequate funds, and strong managerial direction. One obstacle is that organizations often become used to the existing policies and procedures and tend to become biased in their favor, thus making them unaware of and unresponsive to the need for change. Internal auditing often encounters this when it recommends extensive policy or procedural changes. Additionally, people typically do not like to accept change even when the need for it is reasonably clear. Somehow, convenience tends to triumph over objectivity. This means that internal auditors often face a great deal of resistance when suggesting changes, irrespective of the real merits.

When making their recommendations, internal auditors should understand how the organization will deal with the change. How can internal auditing achieve needed change in a manner that will best serve higher-level organizational welfare? In all cases, the nature and scope of the different types of actions depend on the significance of the particular recommended change.

2.4 PHASES OF THE INTERNAL AUDIT PROCESS

Indiana University (2008) stated about the audit process description they use for their clients that although every audit project is unique, the audit process is similar for most engagements and normally consists of four stages: Preliminary Review, Fieldwork, Audit Report, and Audit Follow-up.

2.4.1 Preliminary Review

During the preliminary review portion of the audit, the internal auditor notifies the client of the audit, discusses the scope and objectives of the examination in a formal meeting with the client's organization's management, gathers information on the client's important processes, evaluates existing controls, and plans the remaining audit steps. In this phase, the internal auditor also involves the following processes:

(1) **Announcement Letter:** The client is informed of the audit through an announcement letter from the Internal Audit Director. This letter communicates the scope and objectives of the audit team assigned to the project.

(2) **Initial Meeting:** During this meeting, the client describes the unit or system to be reviewed, the organization, available resources (personnel, facilities, equipment, funds), and other relevant information. The internal auditor meets with the senior officer directly responsible for the unit under review and any staff members he wishes to include. It is important that the client identify issues or areas of special concern that should be addressed.

(3) **Preliminary Survey:** In this phase the auditor gathers relevant information about the unit in order to obtain a general overview of operations. He talks with key personnel and reviews reports, files, and other sources of information.

(4) **Internal Control Review:** The auditor will review the unit's internal control structure, a process which is usually time-consuming. In doing this, the auditor uses a variety of tools and techniques to gather and analyze information about the operation. The review of internal controls helps the auditor determine the areas of highest risk and design tests to be performed in the fieldwork section.

(5) **Audit Program:** Preparation of the audit program concludes the preliminary review phase. This program outlines the fieldwork necessary to achieve the audit objectives.

2.4.2 Fieldwork

The fieldwork concentrates on transaction testing and informal communications. It is during this phase that the auditor determines whether the controls identified during the preliminary review are operating properly and in the manner described by the client. The fieldwork stage concludes with a list of significant findings from which the auditor will prepare a draft of the audit report. This phase also involves the following processes:

(1) **Transaction Testing:** After completing the preliminary review, the auditor performs the procedures in the audit program. These procedures usually test the major internal controls and the accuracy and propriety of the transactions.

(2) **Advice & Informal Communications:** As the fieldwork progresses, the auditor discusses any significant findings with the client. Hopefully,

the client can offer insights and work with the auditor to determine the best method of resolving the finding. These communications are usually by e-mail. An audit observation form is sent via e-mail to ensure full understanding by the client and the auditor of the potential finding. In the response section on the form, the client should explain how findings will be resolved and include an implementation timetable.

(3) **Audit Summary:** Upon completion of the fieldwork, the auditor summarizes the audit findings, conclusions, and recommendations necessary for the audit report discussion draft.

2.4.3 Audit Report

The internal auditors' principal product is the final report in which they express their opinions, present the audit findings, and discuss recommendations for improvements. To facilitate communication and ensure that the recommendations presented in the final report are practical, the auditor discusses the rough draft with the client prior to issuing the final report. This phase involves the following processes:

(1) **Discussion Draft:** At the conclusion of fieldwork, the auditor drafts the report. Audit management thoroughly reviews the audit working papers and the discussion draft before it is presented to the client for comment. This discussion draft is submitted to the client for review before the exit conference.

(2) **Exit Meeting:** Internal Audit meets with the unit's management team to discuss the findings, recommendations, and text of the discussion draft. At this meeting, the client comments on the draft and the group work to reach an agreement on the audit findings.

(3) **Formal Draft:** The auditor prepares a formal draft, taking into account any revisions resulting from the exit conference. When the changes have been reviewed by audit management and the client, the final report is issued.

(4) **Final Report:** Internal Audit distributes the final report electronically to the unit's operating management, the unit's reporting supervisor, the Chief Financial Officer, the Chief Accountant, the President, the Board of Trustees, and other appropriate members of senior management. This report is primarily for internal management use.

(5) **Client Comments:** Finally, as part of Internal Audit's self-evaluation program, the internal auditors ask clients to comment on Internal Audit's

performance. This feedback has proven to be very beneficial to us, and the internal auditors have made changes in the internal auditors' procedures as a result of clients' suggestions.

2.4.4 Audit Follow-Up

Within approximately one year of the final report, the internal auditors will perform a follow-up review to verify the resolution of the report findings. This phase also involves the following processes:

(1) Follow-up Review: The client response letter is reviewed and the actions taken to resolve the audit report findings may be tested to ensure that the desired results were achieved. All unresolved findings will be discussed in the follow-up report and reported to the university President.

(2) Follow-up Report: The review will conclude with a follow-up report which lists the actions taken by the client to resolve the original report findings. Unresolved findings will also appear in the follow-up report and will include a brief description of the findings, the original audit recommendation, the client response, the current condition, and the continued exposure to audit management. A discussion draft of each report with unresolved findings is circulated to the client before the report is issued. The follow-up review results will be circulated to the original report recipients and other internal audit officials as deemed appropriate.

In addition to the aforementioned, internal audit processes of Indiana University, PricewaterhouseCoopers (personal communication, 2008) showed the similar phases of internal audit processes to their clients, as shown in Figure 2.

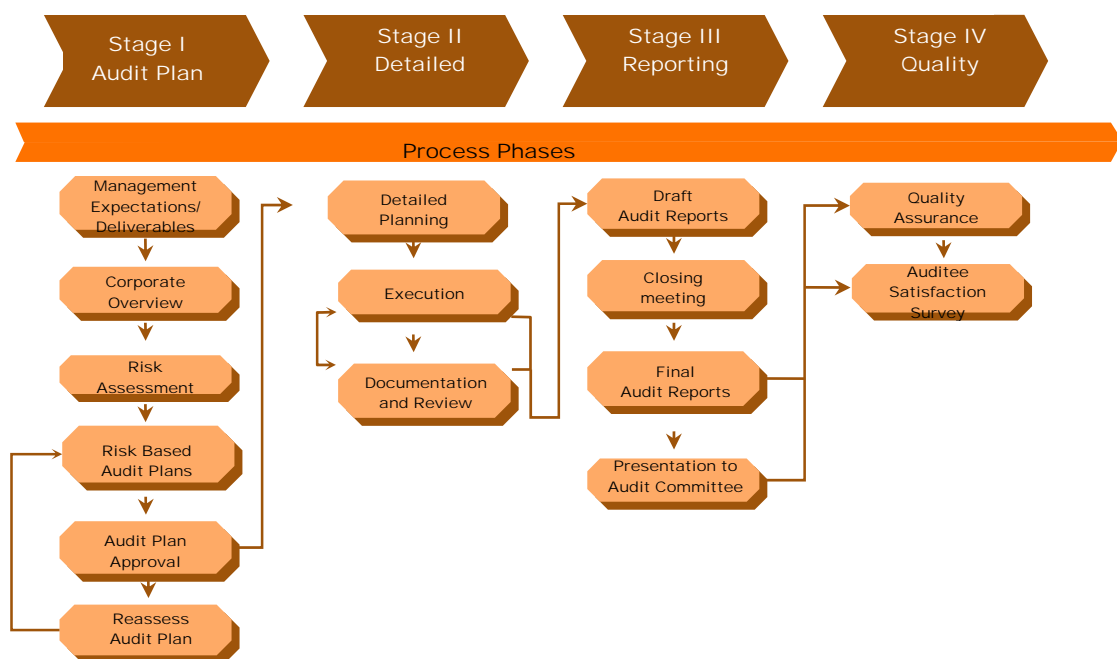
2.5 RELATED RESEARCH STUDIES

The Institute of Internal Auditors Research Foundation or IIARF (2008) shows that one of the ways internal auditors can sustain long-term success of the internal audit profession is to develop a strong working relationship with the audit committee. Below are internal auditors' activities that are critical to having a successful relationship with the audit committee:

1) Send to the audit committee periodic communications on risks faced by the organization.

- 2) Help ensure that the audit committee's charter, activities, and processes are appropriate.
- 3) Ensure that the audit committee clearly understands the internal audit team's charter, role, and activities.
- 4) Be responsive to the needs of the audit committee and the board.
- 5) Maintain open and effective communication with the audit committee.
- 6) Provide training, when appropriate, to audit committee members on the topics of risk and internal control.

Figure 2. Phases of internal audit process.



Moreover, there are a number of international business consulting firms which conducted surveys concerning communication in the internal audit profession. The PricewaterhouseCoopers 2008 State of the Internal Audit Profession Study conducted by PricewaterhouseCoopers (2008) asked respondents to assess a number of value indicators in terms of the perceived importance to audit committees as measures of internal audit value or performance. As a result, the respondents ranked effective communication as the second most important indicator of internal audit value to audit committees. Many audit leaders consider it highly beneficial to meet privately with their audit committees from time to time. According to the survey, 81% of Fortune 500 and 64% of other respondents had conducted private sessions with

their audit committees on a quarterly or more frequent basis during the preceding year. Other survey results reveal the wide range of communication techniques being employed by internal audit leaders to foster good relations with their audit committees as follows:

- 1) 86% of total respondents have open lines of communication with their audit committee chairs.
- 2) 62% of total respondents help set the audit committee agenda.
- 3) 66% of Fortune 500 respondents and 61% of other respondents provide their audit committees with information that extends beyond internal audit reports.
- 4) 45% of total respondents facilitate periodic discussions with their audit committees on key risk topics.

In addition, the 2008 Internal Audit Capabilities and Needs Survey conducted by Protiviti (2008) asked respondents to assess their competency in 18 types of personal skills and capabilities. They were then asked to indicate whether they believe their competency level is adequate or requires improvement, taking into account the circumstances of their organization and the nature of its industry. As a result, as in 2006, 'developing other board committee relationships' is the area in greatest need of improvement for the internal auditors. Presenting or public speaking, developing audit committee relationships and developing outside contacts or networking rank the next highest as areas for improvement.