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# The Need for an Internal Auditor Report to External Stakeholders to Improve Governance Transparency

**Deborah S. Archambeault, F. Todd DeZoort, and Travis P. Holt**

**SYNOPSIS:** This paper considers the need for an internal audit report (IAR) to increase governance transparency for external stakeholders. While the internal audit function is an important and distinct governance mechanism, external stakeholders typically lack the direct relevant information about the function that is available to insiders from other governance mechanisms (e.g., management, audit committee, and external auditor). This information asymmetry is inconsistent with current objectives for governance, transparency, and accountability in the Sarbanes-Oxley era. We evaluate potential IAR disclosure benefits (e.g., increased transparency and accountability) and costs (e.g., increased information load, legal exposure, and reporting costs) using a literature review and the results of 18 semi-structured interviews with analysts, audit committee members, internal auditors, and policymakers. We also propose a model IAR that provides basic descriptive information about the internal audit function for stakeholders to evaluate when considering overall governance within an organization. Ultimately, we conclude that an IAR has potential to complement existing governance disclosures, increase stakeholder confidence in governance quality, and motivate internal audit diligence. However, further research is needed to guide specific report content and to evaluate benefits and costs in both voluntary and mandatory disclosure environments.

## INTRODUCTION

In the Sarbanes-Oxley era, the internal audit function is a critical corporate governance mechanism that is distinct from other governance mechanisms such as an external audit, management, and the audit committee (Deloitte 2006; Gramling et al. 2004; Institute of Internal Auditors [IIA] 2007b; Jackson 2007; Rezaee 2002, 2008; Rosenstein and Rose 2006; Adamec et al. 2005). The IIA (2007c, para. 2) defines internal auditing as:

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> 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.

The importance of an internal audit in overall governance has increased in recent years given the function's critical involvement with internal control over financial reporting (New York Stock Exchange [NYSE] 2004; Public Company Accounting Oversight Board [PCAOB] 2007; Rezaee 2008). For example, in 2004 the NYSE started requiring listed companies to "maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control" (NYSE 2004, Sec. 303A.07).[1]

However, while internal stakeholders have access to detailed internal audit information, external stakeholders (e.g., investors, creditors, analysts, customers, suppliers) lack access to direct and detailed information about internal audit composition, responsibilities, and activities designed to provide assurance related to financial reporting, compliance, and operations.[2] Instead, current governance disclosures available to external stakeholders focus on management, the audit committee, and the external auditor. This information asymmetry has potential implications for stakeholder confidence (e.g., Holt and DeZoort 2008) and contradicts suggestions (e.g., General Accounting Office [GAO] 2002; The Conference Board 2003; World Bank 2006) that transparency is a basic principle of governance.[3]

The purpose of this paper is to evaluate the potential for a formal internal audit report (IAR) to improve governance transparency and stakeholder confidence.[4] Accounting and governance literatures are starting to highlight the potential benefits of IAR disclosure. For example, Mercer (2004, 190) suggests:

> Internal auditors often serve as the first line of defense against disclosure errors, ferreting out unintentional errors caused by weaknesses in a company's internal controls and intentional errors due to fraud. Consequently, if investors can assess internal audit quality, then firms with a strong internal audit department may have higher disclosure credibility... it is difficult for both investors and researchers to determine whether a firm has high-quality internal auditors.

Lapides et al. (2007) call for companies to "consider providing an internal audit report to external stakeholders to describe the internal audit function (e.g., composition, responsibilities, and activities)." Holt and DeZoort (2008) provide initial experimental evidence that IAR disclosure affects investor confidence in company oversight effectiveness and financial reporting reliability. Their results indicate that participants with access to a descriptive IAR (describing internal

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[1] The American Stock Exchange and the NASDAQ do not require listed companies to maintain an internal audit function (Krell 2004). However, the NASDAQ maintains that it is a best practice for its companies to have an effective internal audit function.

[2] Similar to Bailey et al. (2003), we define external stakeholders as groups that have an interest in company activities and an ability to influence the company with their decision making, but lack involvement in company business activities and access to detailed internal information. Given this delimitation, audit committee members and external auditors are not considered external stakeholders given their high level of access to internal information.

[3] External stakeholders may be able to access limited information about the internal audit function indirectly from other governance-related disclosures. For example, management may refer to the internal audit function in its assessment of internal control over financial reporting. Accordingly, we recognize the need for caution and future research when evaluating information asymmetry involving the internal audit function.

[4] We focus on a prospective report to external stakeholders about the internal audit function rather than on current reports from internal auditors to internal stakeholders on financial, operational, and compliance audit results. While our discussion focuses primarily on public (SEC) companies, a majority of the issues discussed are relevant for consideration by public, private, and nonprofit organizations.



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audit composition, responsibilities, and activities) had higher confidence in oversight effectiveness and financial reporting reliability than participants without access. The IAR effects on financial reporting reliability were particularly strong for high-risk companies.

This paper expands consideration of the external IAR's potential to improve governance transparency, decrease information asymmetry, and improve external stakeholder confidence and decisions. We evaluate existing governance disclosures and the potential forms that an IAR could take in voluntary and mandatory disclosure environments. Using a review of the extant literature and the results of 18 semi-structured interviews with audit committee members, analysts, internal auditors, investors, and policymakers, we also contrast potential IAR benefits (e.g., increased transparency, understanding, and accountability) with the potential costs of disclosure (e.g., increased information load, increased liability exposure, and additional reporting costs). Ultimately, while additional research is needed to specify benefits and costs associated with alternative IAR forms in both voluntary and mandatory disclosure environments, we conclude that an IAR has strong potential to improve governance quality and transparency for external stakeholders.

The remainder of the paper is organized as follows. The next section provides background information on the governance transparency problem. The third section describes the method used in the study. The fourth and fifth sections, respectively, consider prospective benefits and costs associated with amending current governance disclosure to include an IAR. The sixth section develops a suggested IAR that could be used as a model to describe internal audit composition, responsibility, accountability, activities, and resources. Finally, the paper concludes with consideration of the paper's policy, research, and practice implications.

## THE GOVERNANCE TRANSPARENCY PROBLEM

The argument for IAR disclosure to external stakeholders focuses on the need to improve governance transparency and reduce information asymmetry costs. Bushman et al. (2004) define governance transparency as the availability and extent of governance-related disclosures. This definition distinguishes governance transparency from financial transparency (i.e., the availability and extent of financial disclosures) as components of corporate transparency.[5] In this context, governance transparency is important to stakeholders who rely on firm-specific governance information to improve confidence and decision making. The Conference Board (2003, 51) noted in its report on governance best practices that "a transparent disclosure approach indicates a commitment to good corporate governance and helps to build trust with shareholders and stakeholders."

A lack of governance transparency represents a source of information risk for external stakeholders. Agency theory (e.g., Jensen and Meckling 1976; Eisenhardt 1989) specifies problems (e.g., moral hazard and adverse selection) emerging in situations where information asymmetry and decision uncertainty exist. In addition, agency theory highlights the importance of governance-related information systems that owners/principals can use to monitor manager/agent performance (Eisenhardt 1989). For example, Fama and Jensen (1983) recognize the importance of the board of directors as an information system that owners can use to monitor self-interested managers. The literature also provides evidence that governance-related disclosures can highlight potential performance problems. For example, Carcello et al. (2002) examine audit committee disclosures shortly after the adoption of mandatory disclosure requirements and find differences between audit committees' reports of duties performed and duties prescribed in their charters.

[5] Bushman et al. (2004) define corporate transparency as the availability and extent of firm-specific information to external stakeholders.



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Overall, the research literature provides evidence that informative disclosures have favorable effects on markets and on external stakeholder judgment and decision making. For example, a number of studies (e.g., Bhat et al. 2006; Farber 2005; Hope 2003; Lang and Lundholm 1996) highlight the link between corporate transparency and analysts' forecast accuracy. Healy and Palepu (2001) review the voluntary disclosure literature and highlight that companies have incentives (e.g., lowered costs of equity, lowered costs of debt, improved market liquidity) to provide disclosure to reduce information risk.

In an assurance context, Kinney (2000, 13) highlights the potential for information assurers to add credibility to financial reporting and improve outsiders' perceptions of information reliability by increasing users' "confidence in the reliability of management's assertions." Bailey et al. (2003) specifically discuss the potential for the internal audit function to help manage information asymmetry problems between internal and external stakeholders. While internal auditors have increased responsibility to provide internal reports and opinions (Dunn 2006), the literature (e.g., Carcello et al. 2002; Mercer 2004) highlights the lack of public information about the internal audit function.[6] We use a multi-method approach to evaluate potential benefits and costs of IAR disclosure and to develop a model report that can serve as a basis for future discussion and research in specific company, industry, and regulatory contexts.

## METHOD

In addition to reviewing the extant governance and internal audit literatures, we conducted 18 semi-structured interviews using a convenience sample of active audit committee members, analysts, internal auditors, and regulators to evaluate their perspectives on potential IAR benefits, costs, and structure. The use of semi-structured interviews provides flexibility that allows new questions and topics to arise (Gendron and Bedard 2006).[7]

We interviewed four active audit committee members (including two audit committee chairs) representing manufacturing, service, and financial organizations. The three financial analysts represented three alternative investment firms. The five internal auditors included three CAEs and represented service, financial, and healthcare organizations. Finally, the six policymakers included two participants each from the American Institute of Certified Public Accountants (AICPA), The IIA, and the Securities and Exchange Commission (SEC). All of the participants had at least ten years of experience dealing with governance and audit-related issues. The interviews averaged approximately 20 minutes.

## BENEFITS OF IAR DISCLOSURE

### Increased Transparency and Understanding of the Internal Audit Function

Our literature review and interview results clearly indicate that an IAR has strong potential to increase stakeholder understanding of the internal audit function and overall governance. While internal audit composition, responsibility, and activity groups vary greatly across companies, SEC officials have repeatedly emphasized the importance of the internal audit function in a company's governance structure (e.g., Herdman 2002; Richards 2002; Gadziala 2005). In addition, Section

[6] The lack of publicly available information about the internal audit function also limits empirical research (e.g., Carcello et al. 2005; Swanger and Chewning 2001; Lowe et al. 1999) primarily to survey and experimental methods. For example, Mercer (2004, 190) notes that the literature lacks research on the relation between "internal audit department strength and disclosure credibility" and suggests that the reason is a lack of internal audit information available to investors and researchers.

[7] Our interview protocol was developed and pretested with three academic researchers with governance-related experience (e.g., as an audit committee member, auditor, or regulator). Pretesting resulted in minor revisions to the interview protocol.



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404 of SOX describes an internal audit's importance by highlighting its unique in-depth organizational knowledge and crucial role in ensuring that internal controls over financial reporting are designed properly and functioning effectively. Financial Accounting Standards Board (FASB) Chairman Robert Herz recognized that "internal auditors are a key party in the financial reporting process... (that can) actively contribute to establishing more effective corporate governance practices" (Salierno 2007, 54). Beasley et al. (2000) found in a study of fraud companies that the existence of an internal audit department was less common among fraud companies than no-fraud companies. Deloitte (2006) noted that without the contribution of an internal audit, many firms would likely be forced to disclose material weaknesses in internal controls over financial reporting.

The research literature highlights the potential for IAR disclosure to help educate stakeholders about the internal audit function and governance role in a way that can affect judgments and decision making. For example, several studies (e.g., Holt and DeZoort 2008; James 2003; Swanger and Chewning 2001; Lowe et al. 1999) provide evidence that internal audit information affects stakeholder perceptions of financial reporting reliability. Holt and DeZoort (2008) evaluated the effect of IAR disclosure on investor confidence in company oversight effectiveness and financial reporting reliability. Their results highlight the potential benefits of IAR disclosure through increased investor confidence and stock attractiveness.

The interview participants consistently emphasized the potential for an IAR to improve transparency and understanding of the internal audit function. For example, one of the analysts stated "absolutely, this type of governance information would be useful in creating a sense of veracity about disclosures." Similarly, one audit committee member participant recognized that an IAR would "increase transparency about an important mechanism that helps ensure financial information is accurate." One policymaker stated "I see two perspectives. In addition to highlighting the nature of the work internal audit performs, the report more importantly will reveal what internal audit is *not* [emphasis added] doing." Finally, one of the internal audit participants acknowledged that "overall, stakeholders are looking for any information they can find about a company... information about internal audit would be useful as stakeholders typically are not privy to this information."

### Accountability, Diligence, and Investment

We also find evidence that IAR disclosure would have potential to increase internal auditor accountability and incentive for diligent performance. Research in psychology (e.g., McAllister et al. 1979) and accounting (e.g., DeZoort et al. 2006) shows that accountability pressure motivates individuals to invest more time and effort in their decision making. To the extent that IAR disclosure increases understanding of the function among external stakeholders, internal auditor accountability and motivation to perform effectively (e.g., ensure activities match stated responsibilities, pursue internal audit best practices) should increase. Furthermore, such increased accountability has the potential to provide internal audit groups with leverage when arguing for critical resources and audit access within the organization.

The interview results provide evidence that supports accountability and increased diligence as benefits of IAR disclosure. For example, one internal auditor participant suggested that "the report would help address questions about what internal audit does... increased transparency may lead to increased quality standardization of, and investment in, internal audit activities." The interviews also revealed suggestions that an IAR would provide incentive for management to provide more support and access to internal auditors. For example, one internal auditor recognized the "potential for increased resource allocation for internal audit if such disclosure is made." Similarly, one policymaker highlighted that "management might not want to reveal a lack of support for the



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internal audit function." One of the audit committee member participants stated that "the net benefit (of the report) would be to hold the internal audit function and management to a higher standard of accountability."

## IAR COST CONSIDERATIONS

### Increased Legal Exposure

One cost consideration is the possibility that IAR disclosure will increase internal auditor legal exposure. For example, highlighting internal audit responsibilities and activities related to internal controls and/or financial reporting could increase interest in internal auditor liability when financial reporting failures (e.g., restatements, fraud) occur. The IIA (2001a) recognizes such liability concern in its Practice Advisory 2400-1, *Legal Considerations in Communicating Results*, detailing items that internal auditors should consider before disclosing engagement results. Dunn (2006) highlights increased internal auditor liability even in internal disclosure contexts where conclusions or opinions are provided to management and the audit committee.

The literature (e.g., McMullen 1996; Rezaee 2002; Turpin and DeZoort 1998) considers the link between descriptive governance disclosures (voluntary and mandatory) and concerns about increased exposure and liability of audit committee members. Turpin and DeZoort (1998) note that one concern surrounding ACR disclosure was that audit committee members would be subject to liability under the Securities Exchange Act of 1934. Rezaee (2002) and McMullen (1996) suggest that increased liability could affect the availability of qualified professionals and increase their compensation. Similar concerns were raised about the potential for increased liability of audit committee members designated as "experts" under the financial expert reporting requirements of SOX 407.[8]

A number of interview participants recognized the IAR's potential to increase internal auditor legal exposure, with the strongest concern coming from the internal auditors. For example, one CAE admitted initial overall skepticism about the IAR idea because of its potential to "lead to additional requirements and liability for the internal audit function." Another internal auditor added, "One key strength of internal auditors is their flexibility within an organization. External reporting requirements that ensure consistency of an internal audit could undermine this strength." Finally, one internal auditor questioned whether the legal department of the auditor's organization would ever sign off on such a report. Conversely, a number of participants indicated that liability concerns should be minimal. For example, one policymaker stated that "while there may be some heightened risk, this risk is clearly offset by the benefits."

### Increased Information Load for Users

Another potential cost to IAR disclosure relates to the increased information load that would be created by an additional governance report in what is already a lengthy and complex corporate disclosure system. Case (2006) notes that information overload may lead to poor decision making because individuals stop paying close attention to details when presented with too much information. Similar information-load concerns circulated prior to the SEC's decision to require ACR disclosure in company proxy statements. The SEC resisted calls to require separate ACRs to shareholders because it questioned whether such disclosure would provide users with useful new information. Turpin and DeZoort (1998) also highlight concern that audit committee disclosures might lead investors to confuse management and audit committee responsibilities.

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[8] The SEC (2003) attempted to address these concerns by providing a "safe harbor" where designation as an audit committee financial expert "does not impose on such person any duties, obligations, or liability that are greater than the duties, obligations, and liability" that the person would have in the absence of such designation.



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Our IAR interview results indicated some awareness of information-load issues. One internal auditor expressed concern that "users may not be able to fully understand the report." Similarly, one analyst suggested that "we may have reached a tipping point with such disclosures." Ultimately, future research is needed to better evaluate the possibility that the incremental cost of adding additional disclosure to already lengthy corporate reports would outweigh the benefits of internal audit transparency.

**Additional Reporting Costs**

Corporate finance theory suggests that disclosure policy is driven endogenously by shareholders who compare the benefits of reduced information asymmetry to the costs of additional disclosure (Core 2001). The literature (e.g., Healy and Palepu 2001) reflects continuing questions about disclosure justification and effectiveness in reducing information asymmetry. For example, Field et al. (2005, 488) highlight concern about "the direct costs of preparing and disseminating information and also various indirect costs such as revealing proprietary information to competitors."[9] Hermalin and Weisbach (2007) suggest that there is a point where increased transparency lowers firm profit because of increased risk for the CEO that leads to increased compensation and turnover. In an internal audit context, Dunn (2006) highlights that extending internal audit reporting to provide conclusions and opinions (e.g., on internal controls) could increase the risks and resulting cost of internal auditing. Such concerns could have unintended negative consequences, including limitations on audit scope and testing because of fear of having to disclose results.

Overall, the interview participants did not consider additional reporting costs to be a major issue in an IAR context. For example, one audit committee member sensed "very low financial and time costs" for internal auditors and organizations. One policymaker linked report cost to internal audit quality, noting that "an internal audit report should be very low cost if internal audit is doing a thorough job." Finally, one internal auditor suggested possible increased reporting costs "if management is involved in report preparation and if the external auditor has to sign-off on the report."

## A PROPOSED IAR MODEL

Overall, the participants provided strong support for the idea of a descriptive IAR. Specifically, 16 of the 18 participants (89 percent) indicated that an IAR would provide external stakeholders with useful information.[10] We propose a model descriptive IAR in this section to highlight the types of information that could be provided to increase external stakeholder understanding of the internal audit function. Clearly, one challenge in developing a model report is to identify and communicate generally relevant internal audit information in an environment with diverse entities and internal audit functions. We use professional standards (e.g., IIA 2007a; AICPA 1991), other existing governance reports, disclosure best practices (e.g., Lapides et al. 2007; PricewaterhouseCoopers [PwC] 2005), and our interview results to develop the proposed report in the Appendix as a model that could serve as a basis for future discussion and adaptation. For example, IIA (2007a) standards state that internal auditors should possess independence, objectivity, proficiency, and due care. Furthermore, model ACRs (e.g., Rittenberg and Nair 1993; Treadway

[9] Field et al. (2005) suggest that the cost of voluntary disclosure of bad news for companies could depend on their litigation risk level. For firms with low litigation risk, the costs of disclosing may exceed the benefits, and consequently these firms will choose not to disclose bad news early.

[10] One analyst and one internal auditor did not believe an IAR would be useful to external stakeholders. The analyst stated that "in a free market system, companies would already disclose such reports voluntarily if they were useful." The internal auditor expressed overall concern given the "drastic variations in what internal audit does across companies."



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Commission 1987; Turpin and DeZoort 1998) provide useful templates with descriptive information about the composition, responsibilities, and activities of the audit committee.[11] The SEC also requires description of the resources that registered companies devote to other governance mechanisms (i.e., management, audit committee, and external auditor).[12] Finally, our interview results provide strong evidence that internal audit composition, responsibility, accountability, activity, and resources are useful categories of information for external stakeholders to evaluate in a descriptive IAR.

**Composition**

While the simple provision of an IAR implies the existence of an internal audit function within an organization, the report can provide additional detail about internal audit composition. For example, external stakeholders could be informed about whether the internal audit function is in-house, outsourced, or co-sourced. For in-house functions, the size of the department and background information about the CAE are relevant for assessing the adequacy of the function. Additional information such as professional designations held by internal auditors (e.g., CPA, CMA, CIA) also is helpful when evaluating the competence of internal audit personnel. For outsourced or co-sourced functions, background information about the service provider is relevant for assessing the appropriateness of the provider.

**Responsibilities**

The internal audit charter provides a reasonable starting point for developing an IAR description of internal audit responsibilities within the organization. The IIA (2007a) states that the CAE should describe the purpose, authority, and responsibilities for internal auditing in a written charter that is approved by the audit committee. This information also is relevant for external stakeholders evaluating the internal audit function as part of overall organizational governance. For example, the responsibilities section of the IAR could provide detail about the prescribed scope and nature of an internal audit's activities. Typically, these responsibilities include maintaining an independent, objective assurance function that is designed to add value to an organization by contributing to the improvement of the company's risk management, control, and governance processes (IIA 2007a). This section also could provide information on an internal audit's responsibilities concerning value-added consulting activities.

**Accountability**

Another important aspect of evaluating an internal audit function is a clear understanding of the function's accountability within the entity. Accountability in this context involves determining internal auditor reporting relationships and whether the function is meeting professional quality standards. While inherently different than the external audit function, internal auditors still pursue independence and objectivity as critical professional objectives. Both objectives can be influenced

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[11] Audit committee disclosures were voluntary prior to 2000. The SEC (1999) mandated descriptive ACRs to improve the reliability and credibility of financial statements. Specifically, the SEC requires proxy statement disclosure that the committee has (1) reviewed and discussed the financial statements with management, (2) discussed with the external auditor all matters required by SAS No. 61, (3) discussed and received a letter regarding external auditor independence, and (4) recommended to the board of directors that the financial statements be included in the company's annual report. Public companies also must disclose the name of the audit committee's financial expert or why the committee does not have one (SEC 2003). In the compensation area, the SEC (2006) requires disclosure of audit committee member compensation and a summary compensation table.

[12] Companies disclose ACRs in their proxy statements. Alternatively, other governance reports (e.g., External Audit Report, MD&A) appear in annual reports. Future research is needed to evaluate whether disclosure site affects stakeholder use in any way.



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by reporting relationships within the company. Internal audit professional standards suggest that "ideally, the CAE should report functionally to the board and administratively to the chief executive officer of the organization" (IIA 2001b).[13] Similarly, Deloitte (2006) notes that in most companies, internal audit departments generally report either to executive management or the audit committee, and suggests that reporting to the audit committee is a better choice in terms of objectivity. Consequently, to provide information relevant to assessing the internal audit function's objectivity and independence, the IAR should provide information describing both functional and administrative reporting relationships. This information would help stakeholders determine the potential for conflicts of interest that could impair objectivity.

One policymaker noted that information about whether an internal audit is meeting professional quality standards also should increase understanding the function's contribution to corporate governance. The IIA's (2007a) *International Standards for the Professional Practice of Internal Auditing* provides guidance for evaluating internal audit performance using quality assurance standards. IAR description of a company's quality assurance and improvement program, results of recent assessments, and disclosure of compliance or noncompliance would provide external stakeholders with a means of assessing internal audit quality and monitoring accountability. Finally, one CAE emphasized the value of "mentioning independent review" to increase credibility.

**Activities**

The nature of internal audit activities (e.g., financial audits, operational audits, compliance audits, risk assessment activities, internal control [SOX Section 404] testing, consulting) varies greatly across companies and even within companies over time. The activities section of the IAR would provide stakeholders with information about the type(s) of work performed by internal auditors. For example, this section could include a description of the percentage of assurance work versus the percentage of consulting work performed during the period by the internal audit function. The activities section also could include information relevant for assessing the nature and frequency of internal audit's interaction with other governance parties. Disclosure of meetings with the external auditor and/or the audit committee, as well as a discussion of the extent of internal audit involvement in the company's financial statement and internal control audits would be disclosed in this section.

**Resources**

The resources section of the IAR would provide users with information about the financial resources devoted to the internal audit function, similar to the existing mandated disclosures about executive compensation, director compensation, and external auditor fees. For outsourced internal audit functions, this would be a disclosure of the fees paid to external parties. For in-house internal audit functions, the annual budget allocated to the internal audit function would be disclosed. One policymaker indicated strong support for a resources section of the report, stating that "investors would like to know" and that such a section "would indicate how serious management is about internal controls within the organization." Similarly, one of the internal auditors stated "the inclusion of resource information may result in increased spending on internal audit."

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[13] Professional guidance provided by The IIA (2002) distinguishes between functional and administrative reporting. Functional reporting refers to the ultimate source of the internal audit function's independence and authority, and covers aspects such as approval of the function's charter, audit plan, appointment and removal of the CAE, and reporting of results of internal audit activities. Administrative reporting, in contrast, facilitates day-to-day operations of the internal audit function, and typically includes human resource administration and administration of the organization's policies and procedures. Administrative reporting should be at a high enough level to ensure sufficient access to key executives and information.



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**Descriptive versus Opinion-Based Reporting**

An evaluation of IAR benefits, costs, and content also should include the effects of extending the report to include an internal audit opinion (or opinions) related to financial reporting, compliance, and/or operations. In a voluntary disclosure environment, internal auditors' liability concerns associated with IARs would likely increase if an opinion was added to basic descriptive detail about the function. For example, the internal audit literature (e.g., IIA 2001a; Dunn 2006) highlights the increased audit costs and potential legal exposure associated with providing specific conclusions and opinions to internal stakeholders. Despite potential liability concerns, internal audit opinions have the potential to provide relevant assurance that complements and extends assurance provided by external auditors related to financial reporting and internal controls. Swanson (2006) highlights that CAEs are increasingly being called on to provide internal audit opinions related to internal control adequacy for executive management, the audit committee, and the board as a whole. These opinions vary widely depending on the scope of the opinion (e.g., financial reporting controls versus entity-wide controls) and the type of assurance provided (i.e., negative versus positive). Professional standards provide specific guidance for internal auditors when providing opinions to stakeholders (IIA 2005).

The interview participants provided mixed reactions to the question of whether an opinion was needed in an IAR to external stakeholders. Eleven participants suggested that an opinion would not increase report usefulness. For example, an internal auditor stated that "one of the strengths of the IAR is that it is purely factual in nature." Some participants' responses reflected perceived difficulty in specifying the focus and scope of an internal audit opinion. For example, one analyst stated that "an opinion might make the report more useful, but it would probably be internal control-based so it may not be much more beneficial that external auditors' internal control opinions." Seven participants advocated adding an opinion or some sort of internal audit findings or outcomes. However, one audit committee member emphasized concern about internal auditor reluctance to provide an opinion of any sort in a voluntary disclosure environment.

## CONCLUSION

Recent accounting scandals and legislation highlight the critical role that the internal audit function plays in corporate governance. Despite this role, external stakeholders typically lack direct, specific information about this key governance mechanism. Our objectives in this paper are to describe the governance transparency problem, the IAR's potential to improve stakeholder confidence and decision making, the costs and benefits of providing such a report, and a proposed descriptive IAR that details internal audit composition, responsibilities, accountability, activities, and resources in a way that has the potential to affect external stakeholder confidence and decision making.

While we describe the IAR's potential to complement existing governance disclosures, we emphasize the need for additional research and discussion by policymakers, practitioners, and researchers to further evaluate the merits and specify the nature of such disclosure. For example, while the results of our interviews and other initial research (e.g., Holt and DeZoort 2008) provide evidence of the IAR's potential to improve stakeholder confidence and decision making, future research is needed to better evaluate the extent that external stakeholders infer adequate information about the internal audit function from existing governance disclosures (e.g., audit committee reports, reports on internal control over financial reporting). Additional research with larger samples also is needed to assess the ability to generalize these findings across external stakeholder groups (e.g., analysts, creditors) given various decisions, contexts, and information needs. Finally, further research is needed to examine alternative report wording effects and the costs and benefits of various IAR types (e.g., descriptive versus opinion-based, voluntary versus mandatory) given



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the wide variety of firm, industry, and regulatory factors that can affect report implementation and efficacy. Our model IAR represents an example report that is intended to serve as a basis for discussion and potential adaptation rather than as a proposed "one-size-fits-all" report.

## APPENDIX
## MODEL DESCRIPTIVE IAR

### Internal Audit Report for XYZ, Inc.

#### *Composition Paragraph*

XYZ, Inc. maintains an in-house Internal Audit Department that was established in (year). The department includes a chief audit executive who supervises x other internal auditors. The chief audit executive is designated a certified internal auditor (CIA) by The Institute of Internal Auditors.

#### *Responsibility Paragraph*

The Internal Audit Department acts under a written charter that is approved annually by the company's audit committee. The charter is included as an appendix to the company's proxy statement, and also is disclosed on the company's website at www.XYZinc.com. In addition to providing assurance and consulting activities designed to add value and improve the company's operations, the Internal Audit Department is responsible for evaluating risk exposures relating to the company's governance, operations, and information systems, in relation to:

- Effectiveness and efficiency of operations;
- Reliability and integrity of financial and operational information;
- Safeguarding of assets; and
- Compliance with laws, regulations, and contracts.

#### *Accountability Paragraph*

The Internal Audit Charter specifies that the Internal Audit Department's independence is established by the company's organizational and reporting structure. This structure requires the company's chief audit executive to report functionally (e.g., receiving approval for activities and reporting results of activities) and administratively (e.g., facilitating day-to-day operations and access to information) to the audit committee.

The Internal Audit Department maintains a quality assurance and improvement program that covers all aspects of internal audit activity and includes periodic internal assessments, external quality assessments at least once every x years, and continuous internal monitoring. The results of the most recent external assessment, an assessment which was conducted by a qualified independent reviewer in 200x, indicate that the Internal Audit Department is currently in compliance with all applicable rules of the professional guidance offered by the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

#### *Activities Paragraph*

The Internal Audit Department's activities during 200x were approximately xx% assurance-related and xx% consulting-related. The scope of these activities was determined by an evaluation of company risk exposures and preapproved by the audit committee. During 200x, the chief audit executive met formally with the audit committee and the company's independent auditors each quarter to discuss internal audit evaluations of the company's risk exposures and internal controls. The chief audit executive also reviewed and discussed the company's audited financial statements and report on internal controls with the audit committee and the independent auditor.



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***Resources Paragraph***

For fiscal 200x, the total cost of maintaining the internal audit function was $xxx,xxx. This amount includes salaries and administrative overhead, and represents approximately xx% of the company's total operating expenses.

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