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Rotational internal audit programs and financial reporting quality: Do compensating controls help? ☆

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ABSTRACT

A report from the Institute of Internal Auditors finds that a majority of Fortune 500 companies systematically rotate internal auditors out of the internal audit function and into operational management (IIA, 2009a). We use semi-structured interviews with 11 chief audit executives and 2 audit committee chairmen to develop an initial framework focusing on how this practice affects financial reporting quality. We then test these associations with archival data and find that companies that use a rotational staffing model for the internal audit function have significantly lower financial reporting quality than companies that do not. However, we find that several compensating controls identified from the interviews (e.g., consistency of IAF leadership or supervision, audit committee oversight, and management oversight and direction) can reduce this adverse financial reporting effect. We conclude that companies should consider the potential costs of using a rotational staffing model in the internal audit function and, if adopting this practice, should ensure the appropriate compensating controls are in place to mitigate such costs.

Introduction

Approximately two-thirds of Fortune 500 companies report that they systematically rotate their internal auditors into management positions outside of internal audit (IIA, 2009a), this practice potentially causes the internal audit function (IAF) to be used or viewed as a training ground for future managers (IIA, 2013). This practice is somewhat perplexing given evidence from prior research suggesting it diminishes internal auditors' objectivity (Messier, Reynolds, Simon, & Wood, 2011; Rose, Rose, & Norman, 2013). We extend prior research on the effects of systematically rotating internal auditors into operational management by conducting interviews with chief audit executives and audit committee chairpersons to develop an initial framework of how this practice is thought to impact financial reporting outcomes. We then

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use this initial framework to guide an archival analysis that tests for the presence of key associations between such rotation and financial reporting quality.

The IAF is required to evaluate the risk exposure and control effectiveness of the financial reporting system (IPPF, 2012). In addition, internal audit is expected to help prevent and detect fraudulent financial reporting (IIA, 2009b; IPPF, 2012) and otherwise constrain aggressive financial reporting (KPMG, 2003; Prawitt, Sharp, & Wood, 2012; Prawitt, Smith, & Wood, 2009; Ege, 2015; Norman, Rose, & Rose, 2010).[1]

However, internal audit functions use a variety of staffing models to fulfill their responsibilities, including a range of systematic rotational programs. Three common types of rotational programs are: (1) hiring new internal auditors from outside of the organization with the expectation that they will spend a (preset) amount of time in internal audit before being promoted into an operational management position, (2) bringing operational personnel into internal audit from within the company for a preset amount of time on their path to operational management, and (3) sending "career" internal auditors into the organization for a brief period of time to experience specific operational processes before returning to internal audit. While this spectrum of rotational programs exists in practice, prior academic literature has focused on the first two types of programs and examined how internal auditors' ultimate goal of obtaining a management position outside of internal audit likely impacts his/her effectiveness as an internal auditor. Both academics and practitioners refer to these types of rotational programs as "management training grounds" (i.e., MTGs) because one of their main purposes is developing future managers' skills by working in internal audit (e.g., Burton, Starliper, Summers, & Wood, 2015; Ege, 2015; IIA, 2013; Messier et al., 2011; Rose et al., 2013).

We posit that specific types of rotational programs have the potential to reduce financial reporting quality. Consistent with prior research, we focus on the systematic rotational programs that result in internal auditors later obtaining management positions because these practices are most prevalent and have the potential to impair financial reporting quality. Hereafter, we refer to these practices as "systematic rotation." This study does not focus on the third type of rotational model, which sends career auditors into operations to gain expertise before returning to internal audit, because that type of rotational program unlikely poses the same risks to objectivity as the two other models.

We investigate whether using systematic rotation models in the IAF affects financial reporting quality in two stages. One, we draw from prior literature on external auditor reliability (e.g., DeAngelo, 1981; Taylor, DeZoort, Thomas, & Munn, 2003) and internal audit quality (e.g., Messier et al., 2011; Prawitt et al., 2009; Rose et al., 2013), as well as regulatory guidance on internal auditor independence and objectivity (IIA, 2001; IPPF, 2012) and external auditors' reliance on internal auditors (e.g., SAS No. 128, No. 65; ISA 610; AS 5) to guide a set of interviews with 11 chief audit executives (CAEs) and 2 audit committee chairmen. Each interviewee provides insights about the use of systematic rotational programs in his/her organization, including the potential costs and benefits of systematic rotation. By integrating the results of these interviews with themes in existing literature and regulatory guidance, we develop an initial framework that we test using archival data.

From the interviews and from prior research, we posit that, in isolation, systematic rotation is likely to impair financial reporting quality. We then advance the theory and literature on this subject by examining whether compensating controls focused on IAF oversight mitigate the adverse effect on financial reporting quality. In particular, our initial framework includes three compensating controls described by our interviewees that we can test: (1) consistency of IAF leadership or supervision, (2) audit committee oversight, and (3) management oversight and direction. Prior research has not identified these potential compensating controls; however, our interviewees believe these controls mitigate the potential impairment of internal auditors' objectivity and competence that likely arises when systematic rotational programs are used, such that the benefits of the practice outweigh the risks.[2]

Two, we conduct archival tests using data collected by the IIA to examine the effects of systematic rotation on financial reporting quality. This proprietary database represents one of the most complete sets of archival internal auditing data that currently exists. The data identify companies that use systematic rotation, other internal audit characteristics that help control for internal audit expertise, audit committee characteristics and activities, and other possible determinants of financial reporting quality, such as firm governance mechanisms (e.g., management and the external auditor). Our proxy for financial reporting quality is accounting risk, which we define as the risk that the audited financial statements contain misleading and/or fraudulent results (e.g., Price, Sharp, & Wood, 2011). We address selection bias arising from unobservable differences in companies that do or do not use systematic rotation with a Heckman self-selection model.

Consistent with our framework, we find that use of systematic rotation is associated with higher accounting risk. This result suggests that systematic rotation weakens the effectiveness of internal audit's monitoring of financial reporting within the organization. This result is also consistent with the view from prior research that some rotational IAFs operate primarily as a management training ground, at the expense of the effectiveness of traditional internal audit activities.

However, consistent with our predictions, other organizations implement compensating controls that mitigate this negative relation. Specifically, organizations that (1) rotate only staff internal audit positions (e.g., not the head

[1] In the most recent Comprehensive Body of Knowledge (CBOK) survey conducted by the Institute of Internal Auditors (IIA), approximately 72% of respondents indicate that their IAF performed audits of financial risks and 71% report that they perform fraud investigations, representing the third and fourth most commonly performed activities, respectively.

[2] While not the focus of this paper, our interviewees also described several important benefits of using rotational programs. We include insights related to these benefits, when relevant, throughout the paper and provide a list of benefits in Table 2.