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# Evaluating Internal Audit Departments Under SAS No. 9\*

## Criteria for Judging Competence, Objectivity, and Performance

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In December, 1975, the Auditing Standards Executive Committee issued Statement on Auditing Standards No. 9, "The Effect of an International Audit Function on the Scope of the Independent Auditor's Examination." This release requires the independent auditor to evaluate the competence, objectivity and performance of internal auditors in determining the degree of reliance to be placed upon the work of the internal audit staff.

The potential reliance of internal auditors in attest activities has been of interest to CPA's for a number of years. For example, as far back as 1956, the Research Committee of the Chicago Chapter of the Institute of Internal Auditors conducted a survey of the cooperation between independent accountants and internal auditors which disclosed a considerable degree of cooperation. In 1962, Tiedemann stated that "There is probably no phase of the public accountant's work that is not affected by a good system of internal audit." [p. 155] He further stated, "The public accountant must evaluate the system of internal audit in the same way he evaluates other aspects of the system of internal control. He must be satisfied that all of the re-

quirements for effective internal auditing have been met." [p. 156]

Sayad in a 1963 speech noted that "The extent to which the independent accountant will be willing to accept the work of the internal auditor . . . will depend upon the evaluation of the system of internal control, the qualifications and effectiveness of the audit staff and his judgment of the various other factors to be considered." [p. 165]

Later, in 1971, Haase noted: "The extent of the internal auditor's participation in the year-end audit typically depends upon

1. The number and availability of internal auditors
2. The extent of their technical proficiency and training
3. Their relative independence
4. The willingness or ability of the outside auditors to delegate certain responsibilities." [p. 41]

Finally, in 1973, two years prior to the issuance of SAS No. 9, Statement on Auditing Standards No. 1, Section 320.74 stated: "Independent auditors should consider the procedures performed by internal auditors in determining the nature, timing and extent of their own tests. The work of internal auditors should be considered as a supplement to, but not as a sub-

stitute for, tests by independent auditors." This provision of SAS No. 1 has now been succeeded by the provision of SAS No. 9.

All of these previous statements have been normative, indicating the need for cooperation between independent accountants and internal auditors. At best, previous work has been descriptive of the types of cooperation which might take place and has provided only a superficial analysis of the problem of external auditor evaluation of the internal audit function. What is lacking is a description of the important criteria used by external auditors in arriving at judgements regarding the internal audit department and a formal process to be used in evaluating the internal audit staff.

At present, independent accountants are faced with abiding by the provisions of SAS No. 9 which require an evaluation of internal audit departments; however, no formal guidelines are provided by which to make this evaluation. The basic areas requiring evaluations are: competence, objectivity and performance. SAS No. 9 requires the external auditor to make assessments of each of these areas which lead to an overall opinion or judgment on the degree of reliability to place upon the work of the internal audit staff. These three assessments are depicted in Exhibit I.

### Objective

The objective of this paper is to provide a list of criteria obtained from a research study to be used by the independent CPA in determining the competence, objectivity and performance of an internal audit department. This objective was subdivided into the following separate parts:

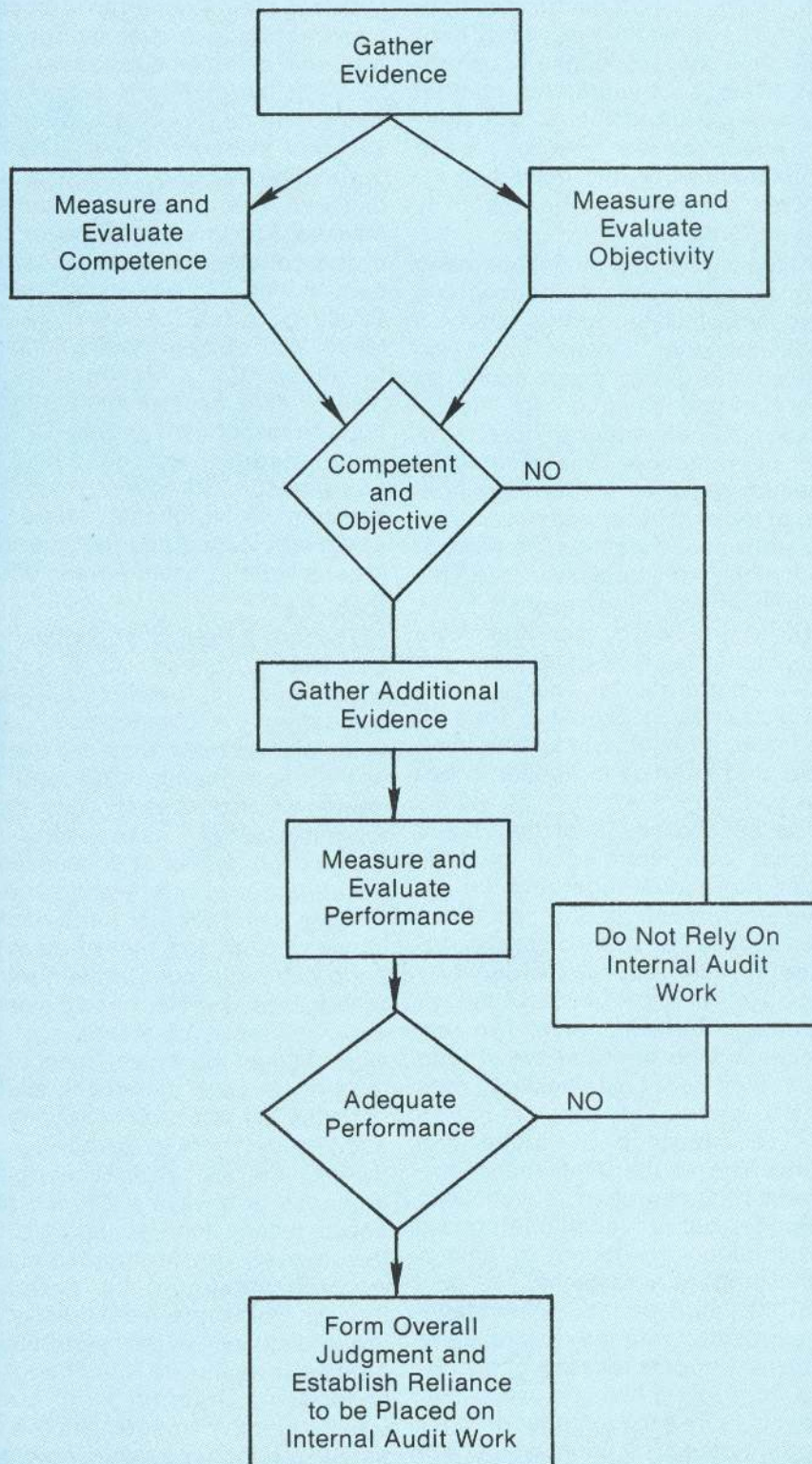
A. Develop an exhaustive list of criteria of internal auditor competence, objectivity and performance.

This list of criteria form the possible information elements which could conceivably be used by an independent auditor in forming an overall judgment on the degree of reliability to place upon the work of an internal audit staff.

B. Reduce the number of criteria to a rank ordering of a manageable number which identifies the major components of the attributes of competence, objectivity and performance.

## EXHIBIT I

### ASSESSMENT OF THE RELIANCE TO BE PLACED UPON INTERNAL AUDIT STAFFS



This list of individual criteria may then be used by independent CPAs to evaluate internal audit departments under the provision of SAS No. 9.

#### The Study

The exhaustive list of criteria from part A was developed by surveying both independent CPAs and internal auditors. In surveying independent CPAs, it was deemed necessary to contact individuals with broad experience in audits of clients with large internal audit staffs. Accordingly, eight large international public accounting firms were contacted and agreed to participate in the survey. Each firm selected twenty-five managers or partners with extensive experience in audits of firms with large internal audit staffs to participate. Questionnaires were delivered to these 200 individuals asking them to detail the criteria used in evaluating internal audit departments. The questionnaire was open-ended but focused upon the provisions of SAS No. 9. Of the 200 questionnaires initially sent, responses were received from 148 individuals for a response rate of 74 percent. The survey of internal auditors was conducted by drawing a random sample of 500 from the 1976 Directory of the Institute of Internal Auditors. Questionnaires similar to those sent to the CPAs were sent directly to each of the selected internal auditors, and 111 usable responses were received for a response rate of 22.2 percent.

The responses were categorized into 54 criteria. Although additional criteria were mentioned, only the criteria mentioned by at least 10 of the total sample of CPA's and internal auditors are included in the next stage of the Research.

There was significant duplication in the criteria mentioned by CPAs and internal auditors. The 54 criteria are not equally applicable to the evaluation of competence, objectivity or performance. For example, the most frequently mentioned criterion, "the educational background of the internal audit staff", probably relates to competence. The second most frequently mentioned criteria, "the quality of internal audit department workpapers", is more closely associated with performance. And, "the independence of the internal audit department", the eighth most

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## What is lacking is a description of the criteria used in making judgments regarding the internal audit staff.

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frequently mentioned item, would appear to be associated with objectivity. The next stage of the research was designed to separate the 54 criteria into those which relate to competence, objectivity and performance.<sup>1</sup>

In the second stage of the study, thirty-nine individuals were selected to serve on an expert panel. This group consisted of 13 partners or managers of international CPA firms with experience in auditing companies with relatively large internal audit departments, 12 internal audit managers of large corporations, and 14 academics with current teaching and research interest in the field of auditing. The composition of this expert panel was designed to include differing points of view, and to enable the researchers to contrast areas of disagreement where they might occur. A form of analysis termed the Delphi Process,<sup>(2)</sup> which attempts to arrive at group consensus, was used in three separate rounds of questioning. After each round, the group was provided feedback and asked to respond to a specific charge.

The initial round of this stage of the research involved completion of a questionnaire which listed the 54 criteria previously developed. The instructions indicated that, "for each criterion, you are to indicate on a scale of 1 to 7 the extent that you believe the criterion to be an important indicator or measure of the components of: 1) competence, 2) objectivity and 3) performance." (On the scale, 1 indicated low importance while 7 indicated high importance). The instructions also indicated that the responses should be independent of one another, that is, that a high or low score on one component had no effect on the remaining two.

As might be expected with a questionnaire of this type, the results of the first round were biased upward in favor of high importance. There was

significant separation of the criteria into those deemed important for the evaluation of competence, objectivity and performance; however, the respondents apparently felt that several of the criteria were important for more than one component. For example, the criterion "form, content and nature of internal audit department reports" was deemed important in the evaluation of all three components. These results apparently indicate that the respondents believe that overall evaluation of internal audit departments must consider some variables which relate simultaneously to the individual attributes of competence, objectivity and performance.

At the conclusion of the first round of this stage of the research, criteria were selected for further study if their individual average score exceeded the group mean score, by one standard deviation for the attributes of competence, objectivity, and performance. This method of selection resulted in the identification of those criteria which were significantly above the average score of each of the individual attributes. This method of selection resulted in 11 criteria that were identified with competence, 9 with objectivity and 12 with performance. These criteria are contained in Exhibit 2. Only 20 are listed; three criteria appear in all areas and three other appear in two areas.

The second round of the Delphi Process was intended to produce better information regarding the relative importance of the remaining criteria, and the upward bias recognized in round one was avoided by forcing a ranking of each of the remaining criteria. In round two respondents were told that the criteria which they were being asked to rank were those found to be most important as measured by round one scores. The results of this round indicated a high degree of consensus in rankings, but an additional round was initiated to attempt to gain a higher level of agreement.

In the third round respondents were provided with the rankings and mean rank scores for each of the criteria from round two, and were then asked to review the information prior to responding. The panel was again asked to rank the given criteria in order of importance to the individual

assessments of competence, objectivity and performance. The rankings and the means of the ranks of this last round are presented in Exhibit 2. Even though several of the criteria shifted in perceived importance, there was substantially greater agreement in the rankings at the conclusion of the third round. This can perhaps best be attributed to the fact that the extreme ranks became more pronounced, even though there was still a rather substantial "grey area" at the mid-point of the mean ranks. The degree of group consensus was measured by a statistical correlation method known as Kendall's W. The group correlations as measured by this technique for each of the components were all significant at the .01 level of probability. These correlations were: competence -.516, objectivity -.605, and performance .235. Additionally, the results were separated in order to analyze respondent groups (CPA, internal auditor and academic). A comparison of these rankings detected no significant differences, and it was concluded that the three groups were in basic agreement.

## Results

The final output of the Delphi Process was a ranked list of criteria which may be used by CPAs in evaluating the competence, objectivity and performance of internal audit departments. Although the degree of responses for each of the attributes varies, these results indicate a high degree of consensus on the attributes of competence and objectivity. On the other hand, lack of consensus on the measurement of performance is not surprising. (The criterion ranking No. 1 had a mean of 4.2). The focus of attention of this study was on the development of criteria to be used by outside evaluators not involved with the internal audit department's day-to-day activities, and the evaluation of performance is always a difficult task. These results tend to indicate that the overall performance of the department should be evaluated through surrogate measures which are indicative of the performance evaluations made by corporate supervisors, internal audit supervisors and top management. (For example, top management's readiness to act on internal audit departmental

*(Continued On Page 22)*

EXHIBIT 2

Criteria to be Used in Evaluating  
Internal Audit Staff Competence, Objectivity, and Performance

DELPHI COMPONENT RANKINGS FOR

Criterion	COMPETENCE		OBJECTIVITY		PERFORMANCE	
	Rank	Mean of Rank	Rank	Mean of Rank	Rank	Mean of Rank
The internal audit staff's knowledge of the company's operations, processes and procedures	1.	2.4				
The educational background of the internal audit staff	2.	3.3				
The internal audit staff's knowledge of new trends and techniques in auditing	3.	3.8			4.	5.7
An existing continuing education program	4.	5.0				
Quantity and quality of supervision within the internal audit department	5.	5.4			6.	6.3
The form, content and nature of internal audit department reports	6.	5.9	5.	6.1	9.	8.4
The internal audit staff's training and experience in EDP	7.	6.6			7.	6.6
The internal audit department's degree of compliance with professional standards	8.	7.0				
The quality of internal audit department workpapers	9.	7.5	6.	6.2	8.	8.1
The existence of documentation in internal audit department workpapers	10.	8.3				
The existence of standards of indexing, cross referencing, and controlling workpapers	11.	10.6	8.	7.0	10.	8.9
The independence of the internal audit department			1.	1.2	2.	2.4
The level at which the internal audit staff reports			2.	3.2		
The ability of the internal audit department to investigate any area of company activity			3.	3.3	3.	5.0
Top management's support of the work of the internal auditing department			4.	3.9		
The existence of review procedures within the internal audit department for audits and reports			7.	6.7		
The internal audit department's degree of compliance with professional standards			9.	7.2	11.	9.0
Top management's readiness to act upon the internal audit department's recommendations					1.	4.2
Acceptance of internal audit staff findings and recommendations by auditees					5.	6.0
The existence of documentation in internal audit department workpapers					12.	9.1

recommendations would indicate a high degree of confidence in the performance of the internal audit staff.)

Finally, it should be noted that this research was focused upon the identification of criteria which might be used by CPAs for the evaluation of internal audit departments under the provision of SAS No. 9. The actual use of these criteria is dependent upon the ability to adequately measure them within particular corporate environments. It is suggested that further research be undertaken which should attempt to develop methods of measurement for each of the criteria identified in this study.Ω

### NOTES

<sup>1</sup>The Authors will furnish a list of these criteria upon request.

<sup>2</sup>The Delphi Process is concerned with the utilization of experts' opinions. It involves the design of a questionnaire on a particular topic of interest that is sent to these experts. After the questionnaire is returned, the results are summarized and a new questionnaire is designed. This questionnaire is returned to the expert panel along with the responses to the original questionnaire. This process is repeated until a consensus of the experts is reached.

### REFERENCES

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<sup>2</sup>Haase, William B., "Cooperation Makes the Difference—How Outside and Internal Auditors Work Together," *Internal Auditor*, July—August, 1973.

<sup>3</sup>Sayad, Homer E., "Opportunities for the Coordination of the Activities of the Internal Auditor and the Independent Public Accountant," *Haskins and Sells Selected Papers*, 1963.

<sup>4</sup>Tiedman, Frank H., "Reliance of Independent Public Accountants on the Work of the Internal Auditor," *Haskins and Sells Selected Papers*, 1962.

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## Reviews

Editor:

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**University of Tennessee**

*Planning and Control in Higher Education*, Anthony J. Gambind; National Association of Accountants, New York, NY, 1979, 115 pages.

Anthony Gambind addresses a timely topic in this book; the application of management planning and control to the not-for-profit sector, specifically higher education. The author's goal is to "investigate the current techniques used in the planning and control of colleges and universities and how they might be improved." To achieve this goal, the author gathers data through a review of the literature, interviews with business officers at 16 colleges and universities, a mail survey of 164 academic administrators, financial administrators, and state-level planners (66 responses). The author does an admirable job in coordinating the results from different data sources in addressing the topics presented. The study presents the results in descriptive form with references to related studies to supplement the research.

The book is divided into six chapters. The introductory chapter describes the higher education environment and provides an overview of the research approach. The second chapter analyses the questionnaire results providing numerous quotes from administrators and planners. Special attention is given to the types and uses of costing, budgeting approaches and output measures. This section highlights the basic problem of an acceptable output measure to evaluate higher education. For this reviewer, the contrasting views provided through the survey presented the most interesting reading. Chapter three outlines the use of costing concepts (full costing, standard costing, and variable costing) and discusses the degree of implementation. Chapter four addresses the need for planning and budgeting with emphasis on Management Information Systems (MIS) and simulation models. Chapter five provides an introduction to Planning, Programming, Budgeting System (PPBS) and Zero-

Base Budgeting (ZBB). The author concludes that these budgeting concepts are not fully understood or utilized. The concluding chapter on the accountability in higher education identifies the problems encountered with subjective outcome measures and performance evaluation. Emphasis is given to the change in the ranking of the major factors used in faculty evaluations.

The primary limitation of the material in the book is the inability of the reader to draw specific conclusions about the data presented due to the lack of any statistical analysis and any generalizations from the benefit of inferential statistics. Even though this limitation is appropriately noted by the author, inclusion would have upgraded the value of the survey. The reader is left to wonder whether the quotes and data presented are representative. Nonetheless, the data presented does provide interesting insight into the topic.

On balance, the author does accomplish the stated objective of examining the current and prospective application of management accounting in higher education. The author delineates the inherent problems faced in planning and control in not-for-profit organizations. Gambind appropriately identifies the inability to directly measure output and the related difficulty of utilizing cost/benefit analysis as the major obstacles faced by colleges and universities in effectively employing managerial accounting.

This book should be of interest to business officers and administrators interested in a "state of the art" presentation on managerial application in colleges and universities. The primary benefit to be derived from the book is an insight into the managerial approaches in use, the advantages and disadvantages of each, implementation problems, and examples of successes and failures.

The research project is well organized, informative, provides interesting reading, and is useful as a general introduction to the topic, is an in-depth expertise is not the intent of the book. The author continually points to the need for additional research in the area.

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