A case study of internal auditing practice in a State-Owned Enterprise in Indonesia

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A Case Study of Internal Auditing Practice in
a State-Owned Enterprise in Indonesia

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Thesis Certification

Certification

I, Helianti Utami, declare that this thesis, submitted in partial fulfillment of the requirements for the award of Doctor of Philosophy, in the School of Accounting, Economics, and Finance, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Helianti Utami

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List of Abbreviations

AAPRC	The Audit Administration of the Peoples Republic of China
AICPA	The American Institute of Certified Public Accountants
AS	Auditing Standards
ASIC	Australian Securities and Investment Commission
ASX	Australia Stock Exchange
Bapepam	The Capital Market Regulatory Body
Bapepam-LK	The Capital Market Regulatory Body and Financial Institution
BL	The Community Development Program
BoD	The Board of Directors
BPK	The Supreme Financial Audit of Indonesian Government
BPKP	The Financial and Development Supervisory Agency
BPPN	The National Bank Restructuring Agency
BSN	The National Standardisation Agency of Indonesia
CA	Certified Accountant
CAE	Chief Audit Executive
Capex Audit	Audit of Capital Expenditure
CCSA	Certified Control Self-Assessment
CEH	Certified Ethical Hacking (CEH)
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CIA	Certified Internal Auditor
CISA	Certified Information System Auditor
COSO	Committee of Sponsoring Organisations
CRMP	Certified Risk Management Professional
CSA	Control Self-Assessment
CSR	Corporate Social Responsibility
DJLK	The Directorate General of Financial Institution
DPR	The House of Representatives
DSQIA	The Certification Boards of Qualified Internal Auditors
EDP	Electronic Data Processing
ERM	Enterprise Risk Management
FCPA	Foreign Corrupt Practices Act
FKSPI	The Communication Forum of SOE's Internal Auditors
FRC	Financial Reporting Council
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Officer
GCG	Good Corporate Governance
GRC unit	Unit of Governance, Risk and Compliance
HRD	Human Resources Department
IAF	Internal Audit Function
IBW	Indische Bedrijvenwet – colonial regulation about the standardised the financial administration of state enterprises
ICoFR	Internal Control over Financial Reporting
ICT	Information and Communication Technology
ICW	Indische Comptabiliteitswet – colonial regulation concerning managerial and financial accountability of the Republic of Indonesia

IDX	Indonesian Stock Exchange
IGGI	The Inter-Governmental Group in Indonesia
IIA	The Institute of Internal Auditors
IMF	The International Monetary Fund
IPPF	The International Professional Practices Framework
ISO	International Organisation for Standardisation
ISPPIA	The International Standards for the Professional Practice of Internal Auditing
IT	Information Technology
KNKG	The National Committee of Governance Policy
KPI	Key Performance Indicators
KPK	The Corruption Eradication Commission
MPR	People's Consultative Assembly
NYSE	New York Stock Exchange
OJK	Indonesia Financial Services Authority
PAII	The Association of Indonesian Internal Auditors
PCAOB	Public Company Accounting Oversight Board
Perdjan	Bureau Enterprise
Persero	Limited Liability Company
Perum	Public Enterprise
PIA	Professional Internal Auditor
PK	Partnership Program
PKBL	Partnership Program and Community Development Program
PN	State Corporation
PPATK	The Indonesian Financial Transaction Reports and Analysis Centre
QAR	Quality Assurance Review
QIA	Qualified Internal Auditor
OIE	The Old Institutional Economics
OJK	The Indonesia Financial Services Authority
RKIA	An Annual Audit Plan
SBY	Susilo Bambang Yudhoyono
SEC	Securities and Exchange Commission
SME	Small Medium Enterprises
SNI	The Indonesian National Standard
SOE	State-Owned Enterprise
SOP	Standard Operating Procedures
SOX 2002	Sarbanes-Oxley Act 2002
SPAI	The Professional Standards of Internal Audit of Indonesia
SPI	Internal Supervisory Unit
US	United States
UK	United Kingdom
YPIA	The Foundation of Internal Audit Education

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ABSTRACT

Internal audit is an important internal control system that contributes to the success of an organisation by enhancing the quality of corporate governance through its oversight role. It also improves the control and monitoring environment of an organisation and mitigates fraud risk. However, the recent corporate collapses in developed countries such as the US and UK as well as increased corruption and fraudulent activities in corporations in developing countries such as Indonesia have raised doubts about the effectiveness of the internal audit function within organisations. Given this background, this study aims to investigate the internal audit practice in an Indonesian public State Owned Enterprise (SOE) using the case study method and institutional theory. More specifically, this study attempts to describe how external pressures which consist of coercive, normative and mimetic shape the practice of internal audit functions in an Indonesian public State Owned Enterprise (SOE).

A public SOE was selected for this case study for a number of reasons. First, SOEs are very important institutions for the Indonesian government as they account for a significant part of government revenue. Second, the effectiveness of the internal auditing practice in SOEs is being questioned due to a number of reported corruption cases involving CEOs of government institutions including SOEs. Third, internal auditing practice of SOEs is subjected to rules and regulations of the government as well as local and international professional bodies.

The study was conducted in a public SOE after it agreed to participate in the study voluntarily. Data for the study was collected using semi-structured interviews from the internal auditors within the internal audit department of this SOE, including the head of the internal audit unit. Publically available data and direct observations made during company visit were also used to collect the data while the qualitative content analysis was employed for data analysis. Furthermore, the responses of the internal audit unit to various institutional pressures were examined using the strategic response framework developed by Oliver (1991) using the approaches recommended by Fogarty (1996).

The study identifies the existence of formal and informal coercive pressures applied to the internal audit unit in a public SOE. Formal coercive pressure comprises the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) or Indonesia Financial Services Authority (OJK), the Ministry of State-Owned Enterprise, the Supreme Financial Audit of Indonesian Government (BPK), the Financial and Development Supervisory Agency (BPKP) and the Indonesian Stock Exchange (IDX). Informal coercive pressure encompasses the Institute of Internal Auditors (IIA), the Sarbanes-Oxley Act 2002 (SOX), the Committee of Sponsoring Organisations (COSO), and the International Organisation for Standardisation (ISO26000). This study found that the internal audit unit responded to the regulations by officially adopting the regulations in the Internal Audit Charter (Charter). For the formal coercive pressures from Bapepam-LK/OJK, the responses of the audit unit consist of four different

strategies and tactics: acquiescence strategy with comply tactic; compromise strategy with pacify tactic; avoidance strategy with conceal tactic; and defiance strategy with dismiss tactic. For the regulations issued by the Ministry of SOEs, the audit unit responded to the pressures by using various strategies and tactics such as acquiescence strategy with comply tactic, compromise strategy with pacify tactic, and avoidance strategy with conceal tactic. In terms of the pressures from BPK regulations, the internal audit unit undertook a compromise strategy and pacify tactic. The acquiescence strategy and comply tactic was found to be used by the internal audit unit in response to the BPKP and IDX regulations. The study also found evidence of the audit unit responding to less formal coercive pressures. In this regard, the unit adopted the compromise strategy and pacify tactic to respond to the expectations of the Institute of Internal Auditors (IIA)/the Indonesian internal auditor associations. The internal audit unit adopted an acquiescence strategy and imitate tactic in responding to Sarbanes-Oxley Act (SOX) 2002 expectation. Regarding the expectations of the Committee of Sponsoring Organisations (COSO), the unit responded by using acquiescence strategy and imitate tactic. In the case of requirements of ISO 26000, the audit unit adopted a compromise strategy and pacify tactic.

The normative pressures are found arise from professional bodies such as IIA/Indonesian internal auditor association and encompass education and training systems, due professional care and continuing professional development. In responding to these normative pressures, the audit unit uses compromise strategy and pacify tactic.

In respect to mimetic pressure, the study found that there were a number of uncertainties faced by the internal audit unit, such as an appropriate technology-based internal control system, the application of ICoFR review and the usage of COSO guidelines in conducting the audit activity. The response of the audit unit to the pressure was indicated by using acquiescence strategy and an imitate tactic.

The study raises a number of policy implications. First, the government should consider making the internal audit unit report directly to the board of directors rather than to the CEO. Second, the government should pay close attention to the report produced by external auditors including the assessments made by the independent assessors on the quality of internal audit activities. Third, the government should continuously up-date the recommendations published by the IIA and adopt them into the regulations to ensure the practice of internal auditing is in line with best standards. Fourth, the government should ensure that their monitoring mechanisms are effective as this study identifies the absence of strong monitoring and inspection mechanisms as one of the main reasons for the internal audit unit's failure to fully comply with government policy requirements. Fifth, the government should monitor and evaluate the qualifications of the auditors in SOEs regularly and take appropriate actions to encourage SOEs to educate their internal auditors.

Furthermore, a number of implications for managers are also highlighted. First, the manager of the audit unit needs to consider the fairness of opportunities for all internal auditors to participate in a professional development program. Second, the

manager of the internal audit unit should recruit new internal auditors as the existing number of internal auditors is not enough to tackle all internal audit activities. Third, the manager of the audit unit should improve the independence and objectivity of internal auditors conducting the internal quality assurance review. Fourth, the manager of the internal audit unit needs to fully understand the changing role of internal auditors and make efforts to provide them opportunities to improve the competencies that are demanded by the newer roles. Five, the manager of the internal audit unit needs to consider the perspectives from different auditors when responding to institutional pressures.

The study contributes to the auditing literature by providing a rich description of internal audit practices of a publicly listed SOE operating in Indonesia that has not previously been subject of a comprehensive study. In this respect, this research contributes to the domain of internal auditing confirms the validity of the application of institutional theory as a lens to examine organisational responses toward various institutional pressures. This study also broadens the level of examination by undertaking a two level examination as suggested by Fogarty (1996). Also, this study has broadens the examination by looking at both formal and informal coercive pressures which have led to responses affecting the internal audit practice. In addition, this study draws up a comprehensive picture of internal audit by covering broader aspects of internal auditing and by involving the activities of all levels of auditors in the internal audit unit. Moreover, this study answers 'how' questions through an interpretative case study to fill the gap in the literature highlighted by Humphrey (2008) who argues that there is a lack of qualitative research in examining internal audit issues. The fact that this study adopts a qualitative case study approach and takes into account the views of various levels of internal auditors and uses a variety of sources for data collection adds to the validity of the findings.

The study has some limitations. First, since a single case study has been conducted to examine the internal audit practice in a public SOE in Indonesia, the findings of the study are subject to the common criticisms of the single case study method such as concerns about the methodological rigour, researcher subjectivity, and external validity. Second, since this study investigated the practice of internal audit in the context of a public SOE in Indonesia, the results of this study may not be relevant to other internal audit units that operate under different contexts and institutional environments. However, despite the above mentioned limitations, this study provides an empirically-rich, context-specific, holistic account of the institutional pressures faced by an Indonesian SOE and describes how such pressures affect the internal audit practice of the Indonesian public SOE examined.

Chapter 1
Introduction

1.1. Statement of Problem

Internal audit functions play an important role in organisations by adding value and improving their efforts to achieve set objectives through a systematic and disciplined approach to control and evaluate operations. However, with corporate governance and accounting scandals in the US and UK in recent years, the effectiveness of the audit functions has been questioned (Allegrini *et al.*, 2009; Schneider, 2003). Similarity, the effectiveness of the internal audit functions in Indonesian companies has come under scrutiny in recent years due to an ever increasing number of corruption and fraud cases within Indonesian companies. As identified by prior research (Diansyah *et al.*, 2012; Umar, 2011; Wicaksono, 2009) ineffective internal audit functions has contributed to the increase in fraud and corruption in government institutions as well as in State-Owned Enterprises (SOEs). During the years of 2001-2004, over 6,000 suspected corruption cases were reported by BPK (the Supreme Financial Audit of Indonesian Government), and more than 700 cases involving corruption were reported by the Financial and Development Supervisory Agency (BPKP), a government internal audit department (Oxford, 2004). In addition, many Chief Executive Officers (CEOs) of the SOEs were convicted by the Corruption Eradication Commission (KPK) on corruption scandals (Umar, 2011).

In response to this situation, the government of Indonesia introduced the Government Regulation No 60 of 2008 to improve the role of internal audit functions in the government sector. As for the State-Owned Enterprises, the government of Indonesia issued regulation No: PER-01/MBU/2011 that requires the SOEs to improve the effectiveness of the internal audit functions.

Despite the importance of internal audit functions and the public knowledge about its ineffectiveness, there has been no prior study investigating the practice of internal audit functions in Indonesian SOEs. As a result, as Power (2003, p. 379) suggests very little is known about the practice of internal audit functions in companies. Furthermore, Mihret *et al.* (2012) highlight the importance of investigating the practice of internal audit functions using institutional theory as it would enable researchers to decode motives for adopting particular practices or design features of the internal audit unit. Humphrey (2008) also laments the lack of qualitative research in examining internal audit issues despite the fact that audit functions are socially constructed. This means that internal audit functions and its processes are affected by diverse aspects of behaviour and institutional environments (Flint, 1988). In order to understand the reasons for internal audit functions practiced, it is necessary to adopt a theoretical framework that views institutional phenomena as its domain (Ball, 1989 cited in Seal, 1993). Given the basic belief of institutional theory that the institutional environment is socially constructed, institutional theory is considered as the most appropriate theory to evaluate and to understand the practice of internal audit functions in SOEs in Indonesia. Given the above background, this study aims to investigate the audit functions of a State-Owned Enterprise in Indonesia with a view to answering a following question:

> How does the practice of internal auditing in an Indonesian SOE react to the coercive, normative and mimetic pressures coming from the environment?

1.2. The Significance of the Study

This research question is worth investigating for two significant reasons. On the practical side, the audit findings of the Supreme Financial Audit on the SOEs show that most internal control systems employed by the SOEs are weak and breach various regulations. Since the internal audit function is part of the internal control system, therefore, an ineffective practice of internal auditing may in turn contribute to the

weaknesses of the internal control system. Therefore, an understanding of the practice of the internal audit function is necessary in order to improve it. That in turn will strengthen the internal control systems, impact on the higher performance of the SOEs and assist companies reduce malpractices, fraud and corruption.

On the theoretical side, as the literature on internal audits show there is a gap in research on internal audit functions, especially in developing countries. The research of internal audit functions using institutional theory mainly deciphers motives for the adoption of internal audit functions in organisations and the features of the internal audit department. Thus, as Mihret (2012) points out, the practice of internal audit functions needs to be studied further. Power (2003) also stated that only a few research focuses on the practice of the internal audit functions, particularly using the qualitative research (Humphrey, 2008). Hence, this study attempts to fill the gap by investigating the practice of internal audit functions in Indonesian SOEs and contributes to the literature by extending the institutional theory to explain the state–owned enterprises in the context of a developing country.

1.3. The Aims and Scope of the Research

The study aims to investigate the practice of internal audit functions in an Indonesian SOE from the perspectives of institutional theory. Hence, the end product of this study will provide evaluation and feedback for the internal auditor, the CEO, the audit committee, the Ministry of SOE, BPK, BPKP, and other stakeholders so that the practice of internal audit functions can be enhanced.

In addition, internal audit functions are socially constructed to meet the needs of society which seeks information about the performance of others (Flint, 1988; Humphrey and Moizer, 1990; Whittington and Pany, 2008). Internationally, the functions of internal audits have evolved as a response to the enactment of many

regulations, such as the US Income Tax Law in 1913 (IIA, 2015); the US Securities Act in 1933 and 1934 (IIA, 2015); the US Foreign Corrupt Practices Act in 1977 (USSEC, 2014), the US Sarbanes-Oxley Act in 2002. It has also evolved in response to the encouragement of numerous professional bodies to implement their guidance such as: the National Commission on Fraudulent Financial Reporting published the guidance of internal control over financial reporting in 1985 (Treadway *et al*., 1987); the Committee of Sponsoring Organisations released the internal control framework in 1992 (COSO, 1994), the UK Cadbury Committee Working Group on Internal Control issued the internal control guidance in 1994 (Vanasco *et al.*, 1995) and the Institute of Internal Auditors (IIA) issued the Standards of Internal Auditing from 1947 to 1999 (Mousa, 2005).

In 1999, the IIA issued a definition of the functions of internal auditing classifying them into two categories, assurance, and consulting. In 2006, the IIA introduced the other function of internal audit namely catalyst function which is presented in the paper issued by the IIA with the title "Organizational Governance: Guidance for Internal Auditors" (Burnaby *et al.*, 2009). The application of these three functions was based on the new paradigm of the internal audit which places the customers of an internal auditor as partners. Hence, the implementation of such functions has impacts on all features of internal auditing and raises potential conflicts concerning independence, professional proficiency, the scope of work of internal auditing, the performance of the audit work, and the management of the internal audit department. However, the IIA also published the Internal Audit Standard as guidance for internal auditors in performing their duties.

However, the practice of internal audit functions within the companies can also be influenced by the environment in which a company operates. This research will look

at the practice of internal audit functions in a public State-Owned Enterprise (SOE) in Indonesia. Specifically, the study investigates such practices within the institutional environment, which consists of government legislation, professional bodies and the uncertain business environment. The SOEs are one of several income sources for the government; therefore all the SOEs are expected to be effective and efficient in their operations to create high financial performance. To meet these expectations, the Ministry of SOEs and the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) or Indonesia Financial Services Authority (OJK) set in place a number of regulations concerning internal auditing. Such regulations provide guidelines for the internal auditors to be effective in achieving the objectives of their functions, one of which is assisting top management achieve the SOE's goals by improving operations in terms of its controls, risks management and its corporate governance process. As professionals of internal auditing, internal auditors are required to follow the International Professional Practices Framework (IPPF) issued by the IIA, which is acknowledged as the worldwide organisation for the internal auditors' profession. The IPPF contains Definition of Internal Auditing, a Code of Ethics, International Standards for the Professional Practice of Internal Auditing (Standards), Position Papers, Practice Advisories and Practice Guides. However, there are some conditions which are not regulated by the regulations nor by the IIA's IPPF, such as the technical procedures for audit of information technology, which motivate the internal auditors of the SOE to find a benchmark to enhance their work performance. Thus, the internal audit functions are expected to be legitimated that is, the functions must be performed to standards as expected by legislation, the Standards of Internal Auditing, as well as business society.

In conclusion, the scope of this research is to look at the practice of internal audit functions in a public SOE in Indonesia. Specifically, this study will focus on how the legislation, the IIA and the uncertain business environment shape such practice.

1.4. Contribution to Knowledge

This research provides practical and theoretical contributions. It makes three practical contributions. Firstly, this study will provide a rich understanding concerning the practice of internal audit functions within an Indonesian SOE which has certain characteristics in terms of the environmental context. Secondly, this research uses the new institutional theory perspective to understand the relevance of the institutional forces in influencing the practices of internal audit functions. Thirdly, this study may assist other SOEs in identifying and addressing issues associated with internal audit functions of their organisations.

The theoretical contribution of this study is to extend the application of institutional theory to explain the practice of internal audit functions in an Indonesian public SOE.

1.5. Brief Research Methodology

A research methodology should be determined before further research is carried out (Bisman, 2010). Bisman (2010) further explains that the ontological and epistemological assumptions are a researcher's guide to choosing a paradigm and theory for study. Ontology deals with the nature of reality (Collis and Hussey, 2003; Creswell, 1998; Denzin and Lincoln, 1998). It consists of two questions: whether reality is socially constructed which means it is a product of people's consciousness and should be treated subjectively, or whether reality is independent and thus should be treated objectively (Creswell, 1998; Eriksson and Kovalianen, 2008). This study perceives that the internal audit functions are socially constructed by the actors to gain legitimacy.

Epistemology is concerned with the process of how knowledge is derived (Bisman, 2010; Collis and Hussey, 2003; Denzin and Lincoln, 1998). Since a social constructionist approach is an ontological assumption used in this study qualitative research is an appropriate epistemological assumption. According to Guba and Lincoln (1998), in order to capture a clearer picture, qualitative research demands researchers lessen their distance from the object being studied (Creswell, 1998). Based on the ontological and epistemological standpoint mentioned above, this study adopted the interpretive paradigm. According to Neuman (2006, p.88), the interpretive paradigm is defined as "the systematic analysis of socially meaningful action through the direct detailed observation of people in natural settings in order to arrive at understandings and interpretations of how people create and maintain their social worlds".

To determine a research strategy, the researcher should consider the type of research questions, level of control over the situation of object being investigated by the researcher, and whether the research focuses on contemporary events or not, as suggested by Yin (2003). Furthermore, according to Yin (2003), a case study approach is an appropriate strategy when the research meets three conditions. Firstly, the form of research question consist of 'how' or 'why' questions. Secondly, the researcher is not required to control the behavioural events. Thirdly, the research focuses on contemporary events. Based on these arguments, a case study design is the most appropriate research strategy for this research. A single-case study was conducted to investigate the practice of internal audit functions within the institutional environment of an Indonesian public SOE context.

An investigation of internal audit function in an SOE is important for a number of reasons. First, SOE plays a significant role in the national economy as one of the main income earners for the government, and in recent years the poor performance of

Indonesian SOEs has created financial difficulty for the government. Therefore, a thorough investigation of its audit function can shed some lights into the systematic issues of SOEs. Second, there is a general perception that some SOEs are involved in corrupt practices as a number of corruption cases were reported against the SOEs by the Supreme Financial Audit of Indonesian Government (BPK), and the Financial and Development Supervisory Agency (BPKP) during 2001 – 2004 in government institutions including SOEs (Oxford, 2004). Furthermore, several CEOs of SOEs were convicted in corruption scandals by the Corruption Eradication Commission (KPK) (Umar, 2011). These incidents raise doubts about the effectiveness of their internal audit practices requiring a comprehensive investigation of such practices. Third, there is a question about the effectiveness of the regulation of government and professional bodies that govern the internal audit practices of SOEs. This is because the internal audit function has not been able to prevent the amount of reported cases of misappropriations of funds by the SOEs. This also requires an investigation of the audit function of SOEs.

This study is conducted using an inductive approach, by which themes and categories are obtained from the data following the method suggested by Zhang and Wildemuth (2009). Data in this study is collected primarily from open-ended interviews in order to explore the experience, understanding and interpretations of the participants relating to the issue being investigated. Documents and direct observation are other data sources used in this research to increase both reliability and validity of qualitative research, as suggested by Miles and Huberman (1994). The analysis of the data follows the following process; (1) employ qualitative content analysis to understand the nature of the investigated phenomena and to interpret the responses of the research participants, (2) analyse the data obtained using the methods suggested by Oliver (1991) and Fogarty

(1996) to see whether the auditing practices identified in the audit charter are adopted and implemented

1.6. Organisation of the Thesis

This thesis is organised into seven chapters. Chapter 1 provides an overall introduction to the thesis, containing a statement of the problem and the research questions, the significance of the study, its aims and scope, research contributions to knowledge, and a brief research methodology. Chapter 2 presents a critical review of internal audit functions and the theoretical framework. Chapter 3 provides the philosophical foundations of the research; the ontology, epistemology, methodology and the method; and the research approach used. Chapter 4 gives a historical account of State-Owned Enterprises in Indonesia and the relevant legislation on internal auditing. Chapter 5 depicts the practice of internal audit in an Indonesian State-Owned Enterprise. Chapter 6 discusses the practice of internal audit using the lens of institutional theory. Chapter 7 presents concluding remarks of this research and the potential for further research.

Chapter 2
Literature Review

2.1. Introduction

The aim of this chapter is to investigate how the practices of internal audit functions is shaped by institutional pressures. This is based on the argument that the practice of internal audit function is necessary to understand in order to facilitate the improvement of the practice. The internal audit functions are socially constructed by the environment surrounding them, therefore, the practice of internal audit can be investigated by understanding the institutional environment which consists of government regulations, professional bodies and the uncertain business condition.

A thorough understanding can be obtained by exploring the existing literature and research findings, so the gap in conceptual issues is clearly identified. This will lead to an understanding of the development of the Internal Audit Function (IAF), the concept of IAF and its nature contained in such a definition as well the practice of IAF; all of which will address three key questions investigated in this study focusing on the institutional pressures shaping the practice of internal audit functions.

2.2. The Development of the Functions of Internal Audit

In order to understand how internal audit functions are shaped by institutional pressures, it is important to trace the development of internal audit functions. The functions of internal audit have evolved. Humphrey and Moizer (1990, p. 219) mention that internal audit functions were “socially-constructed, contextually dependent phenomena, capable of serving a variety of roles and functions”. In this case, the socially-constructed of internal audit functions has occurred to meet the needs of business, governmental and non-profit organisations (Whittington and Pany, 2008).

This argument is strengthened by Flint who declares:

> [a]udit is a social phenomenon. It has no purpose or value except in its practical usefulness. It is wholly utilitarian. The function has evolved in response to a perceived need of individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged or legitimate interest (1988, p.14).

Therefore, the social construction of functions of internal auditing can be traced through the evolution of internal auditing. The auditing was initially applied in Europe by the Greeks and Romans before the birth of Christ (BC) (IIA, 2015) for public finance systems (Ramamoorti, 2003). These early audits focused on "... an examination of the correctness of accounting records and an evaluation of the propriety of activities reflected in the accounts" (IIA, 2015, p.10). This audit activity stressed the improvement of management control over the activities of the entity (IIA, 2015). In 1913, the Sixteenth Amendment of Income Tax Law was passed by the US Congress which had a direct impact on internal auditing (IIA, 2015). Further, this law required all companies, including small ones, to maintain the accounting records for income tax purposes. This condition meant "a need for more accountants and internal auditors – who had to review travel and business expenses for income tax returns and who would respond if the Internal Revenue Service solicited audit reports during their examinations" (IIA, 2015, p.29). Therefore, during early 1900s, the auditing profession was viewed by outsiders as more clerical than professional since they concentrated on the accuracy of book-keeping detail through examining all vouchers and verifying all footings (IIA, 2015), and were focused on financial and accounting matters (Whittington and Pany, 2008). These internal audit activities stemmed from the demand to perform verification for a number of purposes, such as reduction of errors of record-keeping, asset misappropriation and fraud in business and non-business organisations (Ramamoorti, 2003; Whittington and Pany, 2008). In terms of fraud, the internal auditors were

expected to discover fraud more quickly than public accountants who conducted an annual audit, which transformed the function of the internal audit to a search for criminal activity (IIA, 2015; Ramamoorti, 2003).

In the early 1930s, the internal audit concept changed. This was driven by a public swindle scandal committed by Ivar Kreuger that was discovered in 1932 (IIA, 2015). He founded and headed Kreuger & Toll Inc. which was listed in New York Stock Exchange (NYSE) in the US. Kreuger operated a giant pyramid scheme where the dividend payments came from capital rather than profits. This scheme was hidden from the investing public by a failure to audit the company's financial statements. During this period, NYSE had not mandated audited reporting for listed companies. The scandal then led to the issuing of audit requirements for listed companies by the NYSE as well as the publication of the Securities Act (1933) and the Securities Exchange Act (1934) by the Securities and Exchange Commission (SEC) in US in 1933 and 1934 respectively (IIA, 2015). These acts required the firms to be willing to register with the Stock Exchange to provide audited financial statements (Gupta and Ray, 1992). These SEC Acts encouraged all public companies to be responsible for their financial accounting through the maintenance of an internal control system. This control should be audited annually by an independent auditor while the responsibility for more detailed analysis of such control generally falls on the internal audit function (IIA, 2015; Whittington and Pany, 2008). The legislation resulted in the expectation of the internal auditor to work under, as well as assist, the independent auditors in performing financial audits effectively (Gupta and Ray, 1992). For that reason, during 1930s, the internal audit functions in most corporations were perceived as a shadow of independent auditing (Gupta and Ray, 1992).

One decade after that, the Institute of Internal Auditors (IIA) was established in the United States in 1941 to signal the critical importance and relevance of the internal auditing to business (Ramamoorti, 2003) as an administrative control (Thurston, 1950) and to control function (Whittington and Pany, 2008). In this period the activities of internal auditing covered, for example, reviewing financial statements or performing accounting-related functions, such as bank reconciliations (Ramamoorti, 2003). This was also reflected in the definition of internal auditing published by the IIA in 1947, as follows:

> [i]nternal auditing deals primarily with accounting and financial matters but may also properly deal with matters of an operating nature (Mousa, 2005, p.40).

The definition indicated that the internal auditor had a limited responsibility in the managerial orbit (Moeller and Witt, 1999), even though the fundamental purpose of the role lay in the management control area (Milne, 1945 cited in Ramamoorti, 2003). However, the shift to a war economy in the early 1940s triggered the expansion of the internal audit scope beyond the traditional financial audit (IIA, 2015). The expansion was driven by the increasing of size, scope and complexity of business activities which then resulted in the emergence of the need for management to overcome operational problems (Whittington and Pany, 2008). In addition verification of accounting information started to be used for evaluation of business performance and employees as well as decision making (Ramamoorti, 2003). The companies responded to the condition by officially establish the internal audit unit to enable top management to track significant business development through collecting an informative reporting of selected business facts (Mautz, 1964). Furthermore, the internal auditors began directing their efforts towards assisting management to be more concerned with adherence to production scheduling, quality of the product, shortages of materials and labourers and compliance with regulations as well as cost reporting (IIA, 2015; Whittington and Pany,

2008). This indicated that the activities of internal auditing were not merely financial statement auditing, but also included operating auditing (Whittington and Pany, 2008). Thus, the function of internal auditing has gradually expanded from an appraisal of whether authorised accounting and financial policies have been followed to an assessment of the compliance of all operating policies and procedures of the company as well as the soundness and effectiveness of control over all operations (Whittington and Pany, 2008). In other words the internal auditor initially performed audit activity for management which centred on verification of financial transactions, and then gradually emphasised auditing of management approach (Reeve, 1990). The extended function of internal auditing resulted in the requirement of an internal auditor to possess specialised knowledge such as economics, law, finance, statistics, computer processing, engineering, and taxation (Whittington and Pany, 2008).

In 1957, the IIA changed the emphasis of the responsibility of internal auditing to any phase of business activity. This was demonstrated in the new definition of internal auditing issued by the IIA in 1957 as follows:

> [i]A is an independent appraisal activity within an organisation for the review of accounting, financial and other operations as a basic service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls (Mousa, 2005, p.40).

In addition, external audit failures, as indicated by lawsuits in many countries, led to widespread public concern and subsequent legislative and regulatory attention on the internal auditing profession (Verschoor, 1991). Some of this legislation and regulation has been critical to the evolution of the internal audit function. In 1977, the US published the Foreign Corrupt Practices Act (FCPA) which prohibited "the payment of bribes to foreign officials to assist in obtaining or retaining business" (USSEC, 2014). The law was enacted by Congress as a response to cases of bribery of foreign officials to obtain business of US corporations (Vanasco *et al.*, 1995). Therefore, the FCPA

obliges US public companies to document and review their systems of internal accounting control to provide reasonable assurances for all transactions (Kintzele *et al.*, 1993; Loebbecke and Zuber, 1980; Vanasco *et al.*, 1995; Whittington and Pany, 2008). However, the opinion of independent auditors on compliance with the internal control provision of the Act (AICPA, 1991) was not required. In terms of internal auditing, this legislation affects the establishment of internal audit departments in many companies in order to ensure the compliance with the FCPA (Whittington and Pany, 2008). This means the FCPA created a framework for strong integrity of internal auditing (Sawyer, 1988). Furthermore, legislation has greatly changed the function of internal auditing (Reeve, 1990; Vanasco *et al.*, 1995). In this respect, the internal audit units shifted their focus from the accounting quality control to the internal audit control with responsibility to the audit committee of the board of directors rather than the controller (Vanasco *et al.*, 1995).

The enforcement of FCPA was strengthened by the SEC through issuing a new rule for all public corporations in 1979. These companies were required to declare whether the internal accounting control system of the company provided reasonable assurance for the accomplishment of the FCPA's objectives (Kintzele *et al.*, 1993; Loebbecke and Zuber, 1980; Vanasco *et al.*, 1995). Thus, the FCPA along with the SEC constructed the function of internal auditor as the evaluator of the adequacy of internal accounting controls (Courtemanche, 1986).

Increasing business and audit failures in the 1980s prompted the founding in 1985 of an independent body, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission. This Commission was established by five professional bodies, namely American Institute of Certified Public Accountants, the American Accounting Association, the Institute of Internal Auditors, the Financial

Executive Institute, and the Institute of Management Accountants. The Commission emphasises that investors have the right to know the extent of responsibilities of management toward the financial statements and internal control of the company. Therefore, in 1987, the Commission recommended to all top management of public companies to "maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection" (Treadway *et al.*, 1987, p. 11). It is a broader concept than the internal accounting controls set by the FCPA. Moreover, the Commission advocated that all public companies should strengthen their internal control structure (Treadway *et al.*, 1987) by saying:

> [p]ublic companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company ... The internal audit function ... is an important element in preventing and detecting fraudulent financial reporting (Treadway *et al.*, 1987, p.37).

The Treadway Commission provided a more detailed explanation regarding criteria of the effectiveness and objectivity of internal audit function as follows:

> [t]he internal auditor's qualifications, staff, status within the company, reporting lines, and relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity. The internal auditor should consider his audit findings in the context of the company's financial statements and should, to the extent appropriate, coordinate his activities with the activities of the independent public accountant (Treadway *et al.*, 1987, p.11-12).

In addition, the internal audit function performs "an appraisal function within the company to examine, analyse, and make recommendations on matters affecting the company's internal controls" (Treadway *et al.*, 1987, p.20). The Commission also provided a recommendation to the SEC to set a regulation for all public companies that they publicly report responsibilities for maintaining an effective internal control system (Treadway *et al.*, 1987). In this case, the Commission recommended that companies take into account the risks from internal and external environments when planning audit activities (Jeffords *et al.*, 1992; Vanasco *et al*., 1995).

In 1988, in response to the recommendation by the Treadway Commission, the SEC required that annual reports contain a statement by management regarding management’s responsibility over the company’s internal control system and its effectiveness assessment (USSEC, 1988). Meanwhile, the IIA also responded to the Treadway Commission’s recommendation by issuing the publication, “Control in Internal Auditing” (Barrett and Carolus, 1986) which centred on controls assessment and its conceptual framework. In terms of the SEC requirement on the effectiveness of assessment over the control system, the IIA explained that there was no generally accepted measurement criteria for the effectiveness evaluation (IIA, 1989). Moreover, the IIA was concerned that the SEC regulation could impact on more financial statement-oriented reviews of internal audit activity (IIA, 1989).

In response the Committee of Sponsoring Organisations (COSO) of the Treadway Commission developed a common reference of internal control definition and its effectiveness criteria (Bishop *et al.*, 1992; Treadway *et al.*, 1987; Vanasco *et al.* 1995). Thus, in 1992, COSO announced its report of Internal Control-Integrated Framework which was then followed by the similar report in 1994. This report contained the definition of internal control as follows (COSO, 1994, p.3):

> [a] process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
> - Effectiveness and efficiency of operations
> - Reliability of financial reporting
> - Compliance with applicable laws and regulations

The definition of internal control issued by COSO pointed out the broader scope of objectives than internal accounting control which covers operational, financial reporting and compliance (Kintzele *et al.*, 1993; Vanasco *et al.*, 1995). The COSO report provides a common ground for management and internal auditors to identify changes within an entity’s business environment and take necessary actions to manage

risks (Kintzele *et al.*, 1993; Vanasco *et al.*, 1995). COSO (1994) focused on five components of internal control systems that should be addressed in the internal control report: control environment, risk assessment, control activities, information and communication and monitoring. In terms of internal auditing, COSO report gave an opportunity to the internal auditors to participate in:

- defining internal control and related objectives;
- establishing internal control and its components;
- determining appropriate evaluation tools in measuring adequacy and effectiveness of internal control; and
- monitoring internal control continuously and periodically to ensure its objectives are being achieved.
  (Rezaee, 1995, p.8)

Therefore, as internal auditors were required to be experts in these areas they were expected to understand the implications of COSO and other professional and legal requirements and analyse developments in such fields (Vanasco *et al.*, 1995; Wallace and White, 1994). The COSO report expanded the traditional role of internal auditors by identifying the weakness of internal controls and by recommending a new proactive role of internal auditors (Rezaee, 1995).

Meanwhile, the IIA also contributed to the growth of the internal audit function by publishing a definition of internal auditing, indicating its nature, objective, scope, responsibility and independence as well as developing international standards of internal auditing (Sawyer *et al.,* 2003). The definition, issued for the first time in 1947, was revised six times before 1999 reflecting the expansion of the internal audit function (Sawyer *et al.*, 2003). The definition indicated that the functions were developed from both simple functions which only focus on the accounting and financial matters and complex functions that provide a wide range of assurance and consulting services to the management of organisations (Morgan, 1980; Whittington and Pany, 2008). The definition also reveals significant changes in the scope of internal audits from fraud

detection and financial records examination to the economical, efficient, and effective assessment of organisational activities as well as the evaluation of the achievement of organisational objectives (Gupta and Ray, 1992). These changes were highlighted and summarised in Mousa' study (2005) as presented in table 2.1.

Table 2.1. The changes of internal auditing definition (Mousa, 2005, p. 40-43)

Year	Definition of Internal Auditing
1947	IA deals primarily with accounting and financial matters but may also properly deal with matters of an operating nature.
1957	IA is an independent appraisal activity within an organisation for the review of accounting, financial and other operations as a basic service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.
1971	IA is an independent appraisal activity within an organisation for the review of operations as a service to management. It is a managerial control, which functions by measuring and evaluating the effectiveness of other controls.
1981	An independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of IA is to assist members of the organisation in the effective discharge of their responsibilities. To this end, IA furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed.
1991	An independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation and on the board, in the effective discharge of their responsibilities. To this end, IA furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed
1997	An independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. "The objective of IA is to assist all members of organisation in the effective discharge of their responsibilities. To this end, IA furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost. The members of the organisation assisted by IA include those in management and the board of directors.
1999	IA is an independent and objective assurance and consulting activity that is guided by a philosophy of adding value to improve the operations of the organisation. It assists an organisation in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organisation's risk management, control, and governance processes.

In 1994, the Cadbury Committee Working Group on Internal Control in the UK issued guidance of internal controls. The guidance concerned the need to express an opinion on the effectiveness of the internal control system – for which there is no specific legal requirement (Vanasco *et al.*, 1995). In this case, the internal auditor gained the attention of the public eye when the listed companies published reports of the effectiveness of their internal control system.

In 1999, the Turnbull Guidance on internal control in the UK was published. This was prepared by the Institute of Chartered Accountants in England and Wales to assist companies in implementing their internal control systems in accordance with the requirements set by the Combined Code on Corporate Governance (Arena *et al.*, 2006). The Turnbull Report of 1999 created a new perception of the internal audit function by placing the internal auditors as consultants. This is indicated by the request to give recommendations on the potential implementation of new systems and procedures by operational departments (Page and Spira, 2004). The Turnbull Guidance was revised by the Financial Reporting Council and re-published in 2006 (Cosec, 2007). This revision aimed to improve the standards of risk management and internal control for listed companies (Cosec, 2007). The re-definition of internal control within the Turnbull Guidance led to a broader scope of work of internal auditors since the broader approach of internal control gives opportunities for them to have expertise in risk management (Spira and Page, 2003). Spira and Page (2003) further concluded that the Turnbull Guidance has developed the functions of internal auditors as experts in risk management within the corporate governance framework.

Another trigger for internal audit function development occurred in 2002. The collapse in 2001-2002, of a number of large corporations, such as Enron Corporation and MCI Inc. (formerly WorldCom) was primarily due to accounting fraud which demolished the public confidence. The scandal indicated the weakness of the internal audit's role as one of control mechanisms which was important in detecting fraud or misuse of corporate assets (Arena and Azzone, 2007). Arena and Azzone (2007) explain further:

> [i]n the WorldCom case, the internal audit department highlighted the improper recording of large profits from 1999 to 2002. In other cases, such as Enron and Parmalat, the control mechanisms failed to identify existing problems and no evidence of the current situation was provided by internal audit departments (Arena and Azzone, 2007, p. 92).

The scandal of those corporations above led to increasing public demand for better corporate governance, which ultimately affected the development of internal auditing within the organisation (Burnaby *et al.*, 2009). In 2002, to restore public confidence in publicly traded corporations the US Congress passed the Sarbanes-Oxley Act (SOX 2002). This law specified a number of requirements for reporting, transparency, accounting practice and accountability of those in positions of corporate responsibility. Moreover, the SOX 2002 had an impact on internal auditing, particularly with Section 302 (Corporate Responsibility for Financial Reports) and Section 404 (Management Assessment of Internal Controls). Section 302 stipulates that financial reports submitted to the SEC have to be previously certified by the principal executive officer and principal financial officer. Section 404 (Management Assessment of Internal Controls) requires annual internal control reports which:

> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and
> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting (SOX, 2002, p.789).

In a similar vein, Gramling *et al.* (2004, p.196) highlighted a number of items of the SOX 2002 which indirectly enhanced an opportunity for internal audit function to meet the public demand for implement a better corporate governance. These items consisted of:

(1) ... the effectiveness of disclosure controls and procedures with respect to the quarterly and annual reports,
(2) ... to document, evaluate and report on the effectiveness of internal control over financial reporting, and requires external auditor to evaluate and opine on management's assessment of internal control,
(3) ... to establish a whistle[-]blower program[me] to allow for reporting of potential financial accounting problems,
(4) ... disclosure about the adoption of a code of ethics.

The SOX 2002 changed the emphasis of internal auditing in three aspects: the services of auditing, the approaching style, and the audit method (Hass *et al.*, 2006). Hass *et al.* (2006) further explained that the services of internal auditing moved away from detection to prevention, by putting a greater focus on the consulting activities, such as designing the control system. Also, the internal auditing shifted its approach to management from a confrontations style to one where the parties were seen more as partners, and also switched from a controls-to a risk-based approach to the auditing (Hass *et al.*, 2006). Moreover, the SOX 2002 drove the internal auditing towards compliance auditing for publicly listed companies, in particular to concentrate on documenting and testing key internal control over financial reporting (ICoFR) (Hass *et al*., 2006; Whittington and Pany, 2008).

The New York Stock Exchange (NYSE) US responded to SOX 2002 by demanding all publicly traded companies have an internal audit function (Cohen *et al*., 2004; Stewart and Kent, 2006). Also, the internal audit activity of the public companies was required to conform to the SOX 2002 and the statement of Public Company Accounting Oversight Board (PCAOB) on internal control (Burnaby *et al.*, 2009). Thus, both the SOX 2002 and NYSE led to listed companies having an internal audit department and placed internal auditing in an optimum position to deliver the required service. According scholars such as Allegrini *et al.* (2006), Cohen *et al.* (2008), Cooper *et al.* (2006), Paape *et al.* (2003), corporate governance regulation is considered a trigger of changes in the internal audit activities in the US, Europe, Australia and Asia.

This regulation has an impact on the wider scope of works of internal auditors. For instance, the internal audit function is transformed from predominantly an appraisal into consulting (Ahlawat and Lowe 2004, Bou-Raad, 2000; Mihret *et al.*, 2010; Mihret and Woldeyohannis, 2008; Yee *et al.*, 2008; Zain, 2005;), from a traditional or compliance audit to a value added internal audit (Bou-Raad, 2000; Cooper *et al.*, 2006; Gramling *et al.*, 2004; Nagy and Cenker, 2002; Roth, 2002; Stern 1994; Yee *et al.*, 2007). These transformations are through improving the control systems, analysing risks, providing consulting services and reducing the cost of external audits (Burnaby *et al.*, 2006).

Three other prominent scholars, Courtemanche, Sawyer, and Brink, have also examined the changes in internal audit functions. Courtemanche (1991) divided the evolution of internal auditing into two levels: the fundamental concept and the actual practice by audit departments. Courtemanche (1991) further explained an example of fundamental concept that at the conceptual level, from 1947 to 1990, the Statement of Responsibilities issued by the IIA has shown few changes of profession, except for defining the client of an internal audit, from “management” to “organisation”. However, on a practical level internal auditing has changed dramatically. This was indicated by the growth of internal auditing in three stages as follows:

(1) traditional auditing offered financial compliance and fraud auditing services to the controller (and, more recently, to the board audit committee),
(2) Modern internal auditing offered internal control ... and internal consulting services to management,
(3) Neo-modern internal auditing ... views its true master as the organisation itself and interacts with its various components in a manner designed to benefit the whole. (Courtemanche, 1991, p. 107, 109).

In a similar vein, Sawyer (1991) differentiated two aspects of the development of internal auditing - the profession and the practice. In terms of the profession of internal auditing he describes it as dealing with searching for and the achievement of legitimacy. It was related to the “... acceptance or recognition of the true function of modern

internal auditing and the commodity we seek to purvey...a gradual fading of the ancient stereotypes, to be replaced by respect and a call for help" (Sawyer, 1991, p. 38). In the practical aspect of internal auditing there was a greater concern with professionalism. This included two meanings as follows:

- performing work that is technically difficult and that is rooted in the acquisition of relevant knowledge through systematic study and long training – a knowledge that is proved by adherence to standards of performance set by a professional body.
- subscribing to certain ethical values and being objective and fair in all dealings – key attribute of professionalism.
  (Sawyer, 1991, p. 38)

Sawyer (1991) also explained that internal auditing "shifted the focus from the analysis of accounting control to the evaluation of both the adequacy and effectiveness of internal control throughout the organi[s]ation" (p. 41). Sawyer (1991) further stated that for modern auditing this means:

> [t]o anticipate control problems, to visualize and recommend improvement, and to propose preventive action. The emphasis is on protection, rather than detection ... Yet the step into operational auditing is but a way station to a still deeper and broader form of internal auditing as managerial auditing ... as the review and analysis of controls and operations through the eyes of a management consultant (Sawyer, 1991, p. 41).

Brink (1991) summarised the changes in internal auditing as consisting of four levels of enhanced capabilities. At the first level, internal auditing is focused on protection, which means putting greater emphasis on "compliance of accounting and operational procedures, verification of accuracy of calculation, and protection of assets from physical and human forces, and detection of fraud" (p. 9). At the second level, internal auditors have moved away from the image of feared policemen to valued employees "who understand the problems of management and are capable of providing needed controls and problem-solving skills" (p.10). At the third level, internal auditors have shifted from the accounting department to reach a higher level of organisational status and become part of the management team in terms of influence. At the final level,

internal auditors make an adjustment by applying new technology to auditing procedures (Brink, 1991).

Burnaby *et al.* (2009) concluded that the evolution of internal audit functions indicates that:

> [w]hile internal auditing is a global profession and the IIA's Standards and certifications are the same for all countries, the growth of the internal auditing profession has been influenced by new national legislation, stock exchange requirements, and corporate governance standards (p. 858).

Additionally, Vanasco *et al.,* (1995) put forward another conclusion that:

> [g]enerally, governmental influence in auditing is far greater in developing countries. Government agencies in developing countries by and large are more conservative with regard to their fiscal methods, disclosures, and internal control reporting than their counterparts in the USA, the UK, Canada and other developed countries (p. 31).

It can be said that the growth of internal audit functions indicates the socially constructed aspect of internal auditing. In this matter, the government plays a significant role by issuing a number of regulations with impacts on internal auditing. Also, professional bodies set standards for internal auditing which contribute to the development of the internal audit.

The understanding of the current concept of internal auditing and its nature is presented in the next section.

2.3. The Concept of Internal Auditing

The IIA issued an International Professional Practices Framework (IPPF) which includes the Definition of Internal Auditing, Code of Ethics, International Standards for the Professional Practice of Internal Auditing (hereafter: the Standards), Position Papers, Practice Advisories, and Practice Guide (IIA, 2013). The IPPF, particularly the Standards constitute guidance for internal auditors worldwide to perform internal auditing activities in a professional manner (Whittington and Pany, 2008).

The concept of internal auditing is contained in the definition of internal auditing as follows:

> an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes **(**IIA, 2013, p. 2).

This definition of internal auditing was first officially published in June 1999 by the IIA (Nagy and Cenker, 2002). The definition and the Standards are the authoritative references for the internal auditor in undertaking the practice of internal audit (Abdolmohammadi, 2009; Bou-Raad, 2000).

The definition clearly mentions the aims of internal auditing as to add value to the entity by improving the information quality for decision-making (Bou-Raad, 2000). For this purpose, it needs to involve the internal auditor in all operations of the organisation to create and maintain an effective internal control by providing assurance and consulting activities (Bou-Raad, 2000; Driessen and Molenkamp, 1993). These activities must be conducted in an independent and objective manner (Brody and Lowe, 2000; Messier and Schneider, 1988; Rittenberg and Purdy, 1978; Siddiqui and Podder, 2002). Furthermore, the activities of an internal audit include risk management, and control and governance processes that are carried out using a consultative approach and focus on efficiency and the effectiveness of operation (Bou-Raad, 2000). Consequently, current practice of internal audit requires an internal auditor to have broad competence.

Thus, the definition of internal auditing contains some important components, such as the independent and objective nature of the internal auditing activities, the scope of work, the performance of audit work and the professional proficiency of the internal auditor. These elements are presented in next subsections.

2.3.1. Assurance and Consulting Activities, and the Independence and Objectives of the Internal Auditor

The activities of internal auditing are divided into two main activities, namely assurance and consulting activities. The IIA (2013) defines assurance services as "an objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organisation" (p. 42). Similarly, the American Institute of Certified Public Accountants (AICPA) through its Special Committee on Assurance Services (Elliot Report) provides a broader meaning of assurance services as "independent professional services that improve the quality of information or its context for decision makers" (Elliott and Pallais, 1997 p.48). The assurance activities consist of customary internal audits, such as financial audits, performance audits and quick response audits (Anderson, 2003), whilst the IIA provides instances of such services as "financial, performance, compliance, system security, and due diligence engagements" (IIA, 2013, p.42). In terms of the assurance audits, the most important role of internal audit is to provide objective assurance (PwC, 2005). Regarding consulting services, the IIA (2013) provides a description as follows:

> [a]dvisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organisation's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training (IIA, 2013, p. 42).

Essentially, the consulting activities have long been performed as part of the internal audit function's work (Anderson, 2003). These services could include "conducting internal control training, providing advice to management about the control concerns in new systems, drafting policies, and participating in quality teams" (Anderson, 2003, p.106). However, recommendations are given by the internal auditors to management, and it is the right of management to accept or reject the recommendations (Bou-Raad, 2000). Performing as a professional consultant, the

internal auditor's task is only to make recommendations (Bou-Raad, 2000). Burnaby *et al.* (2009) mentioned another function of the internal auditor as a catalyst for change. The catalyst function is "…advising, or advocating improvements to enhance the organisation's governance structure and practices" (Burnaby *et al.*, 2009, p.838). The description of the function is presented in the paper published by the IIA with the title "Organi[s]ational Governance: Guidance for Internal Auditors" (Burnaby *et al.*, 2009).

Both assurance and consulting services are the value-added activities of internal audits that contribute to the success of an organisation (Hass *et al.*, 2006). However, this can only be accomplished if the services focus on the achievement of the objectives of the organisation (Bou-Raad, 2000) and assist the units within an organisation in managing risk and identifying problems as well as providing appropriate recommendations (Allott, 1996). In a similar vein, Cooper *et al.* (1996) explain that current internal auditing is a value added service to organisations since it provides broader consulting services to management on the complexity of business rather than only an internal control review. Similarly, Burnaby *et al.* (1994) describe internal auditing as providing added value by playing a key advisory function in creating and monitoring reliable control systems as well as by being consultants to management in strategic planning. Therefore, the audit function should be strategically aligned with the objectives of the key stakeholders - the audit committee, top management and the external auditor - but must remain independent and objective (Hass *et al.*, 2006).

However, Bou-Raad (2000) argues that a value-added approach requires that internal auditors be adaptable and flexible in their practice, and that management accept the function of internal auditors. The internal auditing may fail to provide a value added activity if top management cannot appreciate or understand the value of the internal audit function (Flesher and Zanzig, 2000). This attitude means audit services will be

underused and audit recommendations will be ignored (Flesher and Zanzig, 2000). Therefore, attitude of top management determines the functioning of the internal audit (Vinten, 1999; Xiangdong, 1997). The degree to which the audited organisation and the internal auditors accept and understand the internal auditor's dual roles will also determine the expansion of the functions of internal audit (Morgan, 1980).

Many researchers have conducted studies on the implementation of assurance and consulting services and their impact on the independence of internal auditors. Rittenberg and Purdy's study (1978) found no negative impact on the independence of internal auditors in 47 large corporations in the USA who were involved in the development and implementation of enterprise systems design. However, according to other scholars (Bou-Raad, 2000; Christopher *et al.*, 2009; Cooper *et al.,* 1996), the implementation of assurance and consulting services creates potential conflicts which may impair the independence of the internal audit. This is because the dual functions of internal auditors, as both monitor and advisor, have different orientations, objectives and characteristics (Brody and Lowe, 2000; Morgan, 1980). Furthermore, Morgan concluded that:

> …combined control-advisory role...can only be successfully achieved at the cost of surrendering certain elements of the controllership role and some of the claims to formal authority which go along with it (Morgan, 1980, p.168).

Indirectly, Morgan states that the internal auditor's functions as controller and also adviser cannot be run simultaneously. Similarly, Nagy and Cenker (2002) discovered that increasing the level of consulting services provided by an internal auditor decreases the level of assurance services provided. Additionally, Brody and Lowe (2000) found that when internal auditors apply new functions, both as the assurance provider and the consultant, this has a number of negative impacts. Firstly, it complicates the independence and objectivity of the internal audit. Secondly, it

diminishes the role of the internal auditor within the relationship between the internal and external auditors. It also reduces the external auditor's trust in the internal auditors' work, resulting in higher external audit fees. Thirdly, it can also decrease the trust of shareholders who expect the internal auditor to conduct his work in an independent and objective manner, otherwise the company could end up facing legal problems.

Glenn (1973) cited in Bou-Raad (2000) noted that expansion of the internal audit services compromise the independence of an internal auditor both in fact and in appearance. Therefore, an "internal auditor will need to address the boundaries of acceptable behaviour and not engage in activities that will likely undermine professional competency" (Bou-Raad, 2000, p.184). Thus, the optimum benefit of internal auditing to an organisation can be accomplished if the internal audit function is independent in fact and in appearance and not directly involved in the process of decision making (Bou-Raad, 2000; Vinten 1999).

Despite contrary arguments on the operation of dual functions of internal audit - as the assurance provider and also a consultant - independence of internal auditing is a key concept (Al-Twaijry *et al.* 2003; Chun, 1997; Hughes, 2004; Messier and Schneider, 1988; Rittenberg and Purdy, 1978). As mentioned by Rittenberg and Purdy (1978, p.51); "the auditor's independence ensures an unbiased review which enhances the auditor's reporting credibility". The independence of the internal auditor provides an effective internal audit service for management, since it gives an objective and unrestrained evaluation, provides an audit report and audit recommendations (Bou-Raad, 2000; Mihret and Yismaw, 2007; Vinten, 1999).

Independence is defined as "the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner" (IIA, 2013, p.43). Scholars interpret the independence of the internal auditor

from different angles. Independence can mean that the internal auditors are free from conflicting duties (Messier and Schenider, 1988), free from the intimidation of top management (such as limitations on audit scope, audit procedures, time restrictions, personnel management process, and resources (Dittenhofer, 2001a; Peursem, 2004)), free from the activities being audited and personnel involved (Bou-Raad, 2000; Chun, 1997; Courtemanche, 1986). Being independent means that the internal auditors are able to express their opinions without any prejudice or threat to their position (Chun, 1997; Sawyer *et al.*, 2003).

The independence of internal auditing comprises organisational independence (also known as the organisational status of an internal audit department within the overall organisation) and objectivity of internal auditors when they undertake audit works (Bou-Raad 2000; Chun, 1997; Courtemanche, 1986; Dittenhofer, 2001a; Driessen and Molenkamp, 1993; Harrell *et al.*, 1989; Hughes, 2004; Suwaidan and Qasim, 2010). According to Dunn (1996), organisational independence is related to supervision of the internal audit department as well as the confirmation of the audit findings. Organisational status confers sufficient power to the internal auditors to enable them to carry out their work effectively (Courtemanche, 1986). Sufficient status within the organisation is important for the internal auditors to be able to fulfil their obligations (Vinten, 1999).

Meanwhile, the objectivity refers to "... a state of mind permitting someone to perceive reality as it truly is" (Courtemanche, 1986, p.37). It is fundamentally performing the duty with intellectual honesty which is reflected in the absence of a conflict of interest (Carmichael *et al.*, 1996). Similarly, Bailey *et al.* (2003, p. 235) define objectivity as "a state of mind in which biases do not inappropriately affect assessments, judgements, and decisions". The objectivity of internal auditors shields

them from the emotional biases, fears, loyalties, and ambitions when they appraise the activity being audited (Courtemanche, 1986). Objectivity of internal auditor also relates to freedom from auditee and management pressures (Courtemanche, 1986). Therefore, auditors have to maintain their objectivity by decreasing their interest to auditee and lessening the power of top management to fire the auditor (Moizer, 1991). Besides, professional ethics require an auditor to report truly regardless of the consequences (Moizer, 1991). Therefore, objectivity of an internal auditor is key to providing recommendations impartially (Vinten, 1999). All these arguments demonstrate the fundamental reasons for maintaining and increasing the independence of internal audits.

According to the scholars, there are various important factors relate to the independence of internal auditing as follows:

- Support from top management in terms of providing sufficient financial support as well as qualified and experienced staff (Adam, 1994; Cohen and Sayag, 2010; Mihret and Yismaw, 2007; Stocks *et al.*, 1988), permitting the auditors to think freely, and assuring the implementation of recommendations (Courtemanche, 1986; Driessen and Molenkamp, 1993; Sawyer *et al.*, 2003).
- Delivery of internal audit reports to the highest management level, the board of directors and the audit committee, in an unrestricted way (Adam, 1994; Al-Twaijry *et al.*, 2004; Braiotta and March, 1992; Burnaby *et al.*, 1994; Courtemanche, 1986; Driessen and Molenkamp, 1993; Hughes, 2004; Sarens, 2009).
- Ensuring internal auditors have unlimited access to all necessary information when undertaking audit activities, such as all physical reality, records and people (Courtemanche, 1986; Sawyer *et al.*, 2003), all activities, decisions and projects of the Chief Executive Officer (CEO), Chief Finance Officer (CFO) and other top executives (Hughes, 2004).
- The internal auditors must be free from conflicts of interest. There must also be a qualified audit committee (Bou-Raad, 2000; Driessen and Molenkamp, 1993).
- The internal audit unit should be located in the higher hierarchy of an organisation as these results in direct responsibility to the board of directors (Bou-Raad, 2000; Driessen and Molenkamp, 1993).

- The functions of internal audit and its responsibilities should be contained in the Internal Audit Charter (Adam, 1994; Courtemanche, 1986; Hughes, 2004).
- Formal meetings should be scheduled between the audit directors and the CEO and CFO as well as the audit committee (Stocks *et al.*, 1988).

Maintaining the independence of internal audit could be triggered by internal or external motivations of an organisation. The internal motivation is driven by an understanding of top management of the benefits of the independent internal audit to the organisation (Moizer, 1991). The external motivation could be activated by government regulations or professional bodies, such as the Institute of Internal Auditor (IIA) (Christopher *et al.*, 2009). For example, the US Foreign Corrupt Practices Act 1977 emphasises the independence of internal audit to assure management integrity in its internal reporting (Moxey, 1979). However, every country has different regulations on the internal auditing. Meanwhile, the IIA is the worldwide professional body of internal auditor but has no legal power to force the implementation of the Standards particularly those regarding the independence of internal auditors. However, the IIA could encourage the internal auditors to be independent. Thus the regulations and the IIA may have an impact on a variety of practices of independence of internal auditors in companies.

A number of researchers attempt to uncover the independence of internal audit in practice. Christopher *et al.* (2009) found some threats to the independence of internal audit in the corporate sector in Australia. These threats are that top management uses the internal audit department as a stepping stone for future managers, that top management is involved in developing internal audit plans, having the budget of internal audit units approved by the CEO or CFO, and that internal auditors are perceived as partners by staff members. Furthermore, threats can also be derived from the relationship between the internal audit unit and the audit committee. For example, if

the internal audit reports are not delivered to the audit committee, when management has the power to appoint and dismiss the head of an internal audit unit, and if none of the audit committee members are qualified in accounting (Christopher *et al.*, 2009).

Similarly, Al-Twaijry *et al.* (2003) discovered a number of threats to the independence of internal audits in the corporate sector in Saudi Arabia. These were: reporting to management; restrictions on the scope of an internal audit and on the freedom of enquiry; and performing non audit activities. A study by Brody and Lowe (2000) found that increasing the role of internal auditors to include consultancy made it difficult for them to function in independent and objective manner. Joseph and Raghunandan (1994) conducted a survey and found that only 33% of companies involved their audit committees in the appointment of heads of internal audit, and only 38% involved them in removal decisions in Canadian companies. Thus, hiring and firing of senior audit staffs are an important area (McHugh and Raghunandan, 1994).

The literature indicates that the implementation of multiple functions of internal audit as a provider of assurance services and also as a consultant may impair the independence of internal auditing. To achieve independence of internal auditing a motive is required. In this case, the understanding of management of the benefit of independence of internal auditing is an internal motivation. On the other hand, external motivation could be obtained from government regulations and the IIA pronouncements. These motivations could be diverse in their application in many companies and countries, resulting in many different practices of the independence of internal audit.

Besides independence and objectivity of internal auditing, the other important feature is the competence of an internal auditor. This aspect is presented in the next subsection.

2.3.2. The Professional Proficiency of an Internal Auditor

The IIA (2013) describes professional proficiency as follows:

> [k]nowledge, skills, and other competencies is a collective term that refers to the professional proficiency required of internal auditors to effectively carry out their professional responsibilities (p. 19).

In general, proficiency is also known as competence, which is defined as “the ability to perform to recognised standards” (Jessup, 1991, p.25), whilst in occupational terms, it is described as “the repertoire of skills, knowledge and understanding which he or she can apply in a range of contexts and organisations” (Jessup, 1991, p.25).

The competence of internal auditors should be one of organisations’ top priorities since it provides plenty of benefits for them (Engle, 1999). First, the audit activities conducted by internal auditors contribute to the attainment of organisational goals. Second, external auditors could rely on the works of internal auditors which may reduce the fees of external audit. Third, internal auditors who understand the audited organisation are in the best position to give information concerning financial statements (Engle, 1999). In similar vein, Selim *et al.* (2014) claim that Chief Audit Executive (CAE) competence affects the credibility of internal audit function.

Alzeban and Sawan (2013) mentioned that qualified internal auditors are required to execute audit duties. In this matter, scholars have diverse standpoints on the components of the internal auditor’s competence. Bethea (1992), Desai *et al.* (2010), and Tarr (2002) consider the educational level and professional experience as essential factors of the competence of internal auditor, whilst Obeid (2010) agrees but includes training as an additional important element of competence. Other scholars such as Mulugeta (2008), Odar *et al*. (2006) use professional certifications and continuing professional development as indicators of the competence of internal auditor. Pickett (2000) identifies professional qualifications, knowledge sharing between experienced

senior auditors and junior auditors, external seminars as training media, and reliance on experts as creating an internal auditor's competence. Al-Twaijry *et al.* (2004) state that the operations, processes and procedures of a company as well as the quality and quantity of supervision conducted by the internal audit department determine the competence of an internal auditor. The US Statement of Auditing Standards No 65 (AICPA, 1991) provides seven criteria as guidance for external auditors to assess the competence of internal auditors as follow:

- Educational level and professional experience of internal auditors.
- Professional certification and continuing education.
- Audit policies, program[me]s and procedures.
- Practices regarding assignment of internal auditors
- Supervision and review of internal auditors' activities.
- Quality of working-paper documentation, reports, and recommendations.
- Evaluation of internal auditors' performance.
  (p. 1807).

In addition, the competence should be relevant to the scope of the internal audit activities (Driessen and Molenkamp, 1993). Therefore, competence should cover: accounting and auditing knowledge (Dittenhofer, 2001a; Dittenhofer 2001b); communication skills (Dittenhofer, 2001a); various technical skills (Siddiqui and Podder, 2002). The ability of the internal auditors who undertake monitoring and improving of risk management and internal control systems will be determined by their education level, their work experiences, professional certifications, training and development programmes completed, behavioural skills, as well as technical skills (Sarens, 2009).

Thus, proficiency of internal auditors is created through a number of media, such as education, working experiences, training and professional certifications, participating in continuous professional development programmes and skills. These elements are discussed in more detail in the four next subsections.

2.3.2.1. Educational Background

There are several studies on the educational background of internal auditors. Some studies suggest that internal auditors should obtain internal auditing courses through academic providers to meet an educational qualification. A survey conducted by Cooper *et al.* (1994) suggested that Australian chief executives and managers of internal audit in public and private sectors recognise the importance of having internal audit courses and programmes in universities. Besides the internal auditing knowledge, it is crucial for the internal auditors to have an understanding of foundation business subjects as well as the functions and skills learned in upper level management courses (Hass *et al.,* 2006). In terms of the internal audit course curriculum, it is important to identify course objectives, course contents, methods of instruction, the IIA involvement, and course evaluation which would improve the students' understanding of internal audit function (Fernandes *et al.* (1995).

A number of researchers (Al-Twaijry, 2000; Al-Twaijry, 2006; Asairy, 1993) conducted studies in Saudi Arabia. As their studies revealed that only two universities offered internal audit courses, they proposed the inclusion of internal audit as separate courses in universities in Saudi Arabia. However, participant responses to questionnaires showed that directors of internal audit units and the staff were well educated in the corporate sector in Saudi Arabia (Al-Twaijry *et al.,* 2003).

2.3.2.2. Professional Certifications

The robustness of the internal audit process is sustained through ensuring the continuation of the internal auditors' qualification (Felts, 1994). The need for quality could be accomplished by gaining a Certified Internal Auditor (CIA) certification issued by the IIA. CIA is a certificate for internal auditors as an evidence of expertise in internal audit (Al-Twaijry *et al.*, 2003). Therefore, if directors and staff of internal audit

do not have a CIA certificate, then their activities cannot be seen as giving a legitimate contribution to the organisation (Al-Twaijry *et al.*, 2003). To become a CIA, internal auditors are required to fulfil a number of requirements, such as possessing a Bachelor’s degree, passing the professional examinations, having professional experience in the auditing field, applying IIA's Code of Ethics, and committing to a continuing professional development programme (Myers and Gramling, 1997).

A number of studies concern the professional qualification. Agrawal and Siegel (1989) discovered that the motivation of 68% internal auditors in the US taking the CIA certification was linked to professional advancement. Myers and Gramling (1997) found that internal auditors who have CIA qualification obtain advantages, in terms of professional development and promotion. However, Vinten (2004) found that the professional certification did not contribute to such advancement. Other negative effects of having professional certification were discovered in Kwon and Banks’ study (2004). They found that certified internal auditors were less committed to their employers than internal auditors without professional certification.

Al-Twaijry *et al.* (2003) revealed that few directors of internal audit units or staff in the corporate sector in Saudi Arabia have CIA or other professional qualifications. They suggested that the low level of affiliation to the IIA in Saudi Arabia is the reason. This is because the professionalism criteria of internal auditors refer to Standard of Professional Practice issued by the IIA (Ratliff *et al.*, 1988).

2.3.2.3. Continuing Professional Development

To maintain an alignment with changing internal audit functions and the extension of the areas of involvement in risk management, control and governance processes, internal auditors need to redesign their skill set and competencies (Arena and Azzone, (2009). This includes reshaping the foundational knowledge of internal auditors which

should embrace “an understanding of the business, the competitive nature of the industry, and the linkages of all functional and operational areas in the company” (Hass *et al.*, 2006, p. 841). Therefore, the internal auditors should develop the talent necessary for maintaining effective value adding in their audit activity (Sumners and Soileau, 2008).

In order to face this challenge, the internal auditors need to “undertake continual professional development to keep up to date with changing business practices and remain capable of providing a value-added service” (Bou-Raad, 2000, p.183). A continual professional development programme could be obtained by taking continuous training, such as updating knowledge of both auditing techniques and organisational activities (Tarr, 2002), as a member of and participant in a professional organisational, attending conferences and seminars (IIA, 2013).

Some professional training will lead to certification as evidence for the qualification of internal auditor, such as CIA. The training aims “to modify attitudes, knowledge or skill behaviour through learning experience to achieve effective performance in an activity or range of activities ... [and] ... to develop the abilities of the individual and to satisfy the current and future needs of the organisation” (Beardwell and Holden, 2004, p. 336).

There are three kinds of training for the internal auditor: external, on-site and internal training (Johnson, 1991). Johnson (1991) describes external training as being held outside of an organisation by professional organisations such as the IIA, accounting firms and accounting bodies. The material of this training covers a range of fundamental audit skills, and technical as well as management training. On-site or in-house training is training performed within an organisation by bringing in external experts. The internal training is developed by organisations themselves with their

internal experts who develop the training materials. There are three benefits of training: it raises confidence and self-esteem, offers great opportunities for networking and ensures commitment to the profession (Espersen, cited in Johnson, 1991).

Since continuing professional development programmes are important to ensure the quality of internal audit activities through updating knowledge, skills and competence of internal auditors, the companies and the internal audit unit should pay serious attention to the programme. However, a number of studies indicate that internal audit departments as well as top management of some companies are not aware of the benefit of professional development programmes. These companies suffer a shortage of qualified staff as the auditors have few opportunities to participate in training activities (Ahmad *et al.*, 2009; Ali *et al.*, 2007; Al-Twaijry *et al.*, 2003).

2.3.2.4. Skills

Having multiple skills is important for the internal auditors. The auditor should be able to demonstrate a wide range of technical abilities to understand the criteria used in evaluating different types of evidence for proper conclusions (Siddiqui and Podder, 2002). Internal auditors are engaged in a range of activities from beginning to end that need both planning and implementation and they need to be qualified to perform these duties. This simply means that the internal auditors must possess certain skills to collect, analyse, interpret and record information to explain the results. For example, in carrying out an operating audit, the team of internal auditors ought to possess knowledge of and experience in accountancy, business economics, information technology, logistics and behavioural sciences (Driessen and Molenkamp, 1993).

Bou-Raad (2000) highlights that the internal auditors should have capabilities in logical thinking, research ability and business related skills. This means that the auditors should understand the business processes that keep changing dynamically in line with

information technology. This is supported by a number of studies which demonstrates that internal auditors need to improve their technical skills in areas such as information security, enterprise risk management, fraud risk management, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) Enterprise Risk Management (ERM) framework (Marshall and Magliozzi, 2009), technology oriented internal audits and information technology (IT) audits (Abdolmohammadi and Boss, 2010). The skill for undertaking information technology (IT) audit requires internal auditors to blend accounting knowledge with that of implementation, operation, and maintenance of IT systems (Merhout and Buchman, 2007). Similarly, recently the IIA (2013) highlighted the importance of knowledge to evaluate the risk of fraud as well as information technology risks and controls.

The literature indicates that it is extremely important for internal auditors to possess and maintain competencies which are relevant within their working areas. Likewise, it is critical for internal auditors to maintain a relationship with the IIA as the professional body and to follow its published guidance. It would benefit internal auditors to be admitted as a qualified internal auditor and also enable them to make a value-added contribution to the organisation. However, enhancing the proficiency of internal auditors is not compulsory, it is voluntarily in nature since it is encouraged by the professional body. Moreover, the continuing improvement of competencies of internal auditors needs high commitment from the internal auditors themselves and also from top management since this activity needs high investment from the organisation. The fact that studies are not in agreement over this issue indicates that further investigation into the practice of internal auditors’ competencies is warranted.

The competence of the internal auditor is absolutely necessary in the internal auditing activities. The scope of work of internal auditing will be presented in the next subsection.

2.3.3. Scope of Work of Internal Auditing

The scope of works cannot be separated from the functions of internal audit. The expanded scope of work reflects the evolved functions. The extended internal audit's works as well as functions are contained in the definition of internal auditing issued by IIA. The definition demonstrates that there are three major domains of internal auditing which consist of internal control, risk management and governance process (IIA, 2013). For this range of works, the functions of internal auditing cover being both provider of assurance services and consultant as indicated by the definition (IIA, 2013). Moreover, there is a specific function in the governance context which is known as the agent of change (Burnaby *et al.*, 2009).

As presented in the previous section, government regulations and professional bodies, such as the IIA, had an impact on the expanded functions of the internal audit. However, Courtemanche (1986) argued that the expanded functions of internal audit are only determined by top management and the internal auditors.

The functions of internal audit and its scope of work have been expanded to cover more activities (Cohen *et al*., 2004; Gramling *et al*., 2004). Traditionally, internal audit functions focussed mainly on compliance, monitoring, and examining the performance of line managers. However, the new functions give emphasis to improve corporate performance, link to risk management and help managers understand the potential obstacles in achieving a company's goals (Bou-Raad, 2000; COSO, 2004; Matyjewicz and D'Arcangelo, 2004). Furthermore, Committee of Sponsoring Organisations (COSO) stresses the specific scope of internal audit on "... the examination and evaluation of the

adequacy and effectiveness of the organi[s]ation's system of internal control and the quality of the performance in carrying out assigned responsibilities" (COSO, 2011, p. 138). Chambers and Odar (2015) argue that internal audit scope should go beyond compliance, governance, risk management and internal control processes. The internal auditors should consider "the quality of the inputs to, and the outputs from these processes, and to identify and report any unacceptable levels of risk" (Chambers and Odar, 2015, p.46).

Similarly, a number of research findings also reveal radical changes in the internal audit professions in that internal audit is perceived as both an assurance and a consulting activity, enabling it to function primarily as the key role in corporate governance and risk management. Other studies in Australia and USA support this change (Burnaby and Hass, 2009; Cooper *et al*., 2006; Hass *et al*., 2006; Nagy and Cenker, 2002). Empirical evidence from Europe indicates an increased focus of internal audit activities on consulting, governance, IT and management audits, but less emphasis on the fields of compliance and financial audits (Allegrini *et al*., 2006; Paape *et al*., 2003). The change in the internal audit's orientation towards value-added services and away from traditional assurance service is presented by the study of Kagermann *et al*., (2008). These changes mean therefore, that the activities of internal audits will spend less time on operational audits, reviews of financial processes and regulatory compliance audits (Burnaby and Hass, 2009). Arena and Azzone (2009) suggested that in order to improve the internal audit value-added service the internal audit functions could increase their involvement in activities which support risk management and provide recommendation to vital systems, procedures and processes. It is predicted that in the coming years, changes in technology and the role changing in the internal audit departments will have a strong impact on the internal audit function practice (PwC,

2007). Therefore, having sufficient understanding of these issues is essential in order that the internal auditing can provide added value to the companies. However, subsequent research on the changing activities of the internal audit function has been taken in only a small number of cases (Selim *et al*., 2009) while changes in the internal audit environment have been significant (Munro and Stewart, 2010).

According to a number of scholars, the advantages of internal audit functions consist of reviewing operational efficiency, analysis of the outcomes of a financial plan, informing business activities to management (Cooper *et al.,* 1996), assisting in the processes of acquisitions, mergers, systems development and implementation (Brody and Lowe, 2000), and satisfying business objectives (Bou-Raad, 2000). However, "[t]he value contributed by the internal audit activity to the organi[s]ation's success may be compromised or devalued if the Standards are not followed" (Burnaby *et al*., 2009, p. 835).

2.3.3.1. Risk Management

The glossary of the IIA (2013) provides the meaning of risk as follows:

> [t]he possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood (p.43).

While their definition of risk management is as follows:

> [a] process to identify, assess, manage and control potential events or situations to provide reasonable assurance regarding the achievement of the organi[s]ation's objectives (IIA, 2013, p.43).

The Standards of internal auditing provide guidance for the internal auditor to conclude the effectiveness of risk management by assessing whether (IIA, 2013, p. 30):

- Organi[s]ational objectives support and align with the organi[s]ation's mission;
- Significant risks are identified and assessed;
- Appropriate risk responses are selected that align risks with the organi[s]ation's risk appetite; and
- Relevant risk information is captured and communicated in a timely manner across the organi[s]ation, enabling staff, management, and the board to carry out their responsibilities.

Barry (2000) suggested that internal auditors should communicate an annual audit plan, the objectives of internal audit and its risk-based audit approach to senior management. In this respect, the communication should cover explanation of the risk, the risk assessment process, the high-risk areas within the projects and the risk priorities of internal audit. This means that besides providing objective assurance, the auditor is also required to give recommendations on risks and controls to senior management and the board. For this purpose, the Turnbull Guidance 23 of UK (2005) underlined the important of adequately resourced internal audit function. The proper resourcing of the internal audit function can provide unbiased information from line managers, monitor an organisation's risk profile, improve the risk management processes and emend the system as a part of consultancy services (ECIIA, 2005; Leithhead, 2000; Lindow and Race, 2002; Page and Spira, 2004; Spira and Page, 2003).

A number of studies found that there is awareness among internal auditors and senior management that the internal auditor plays a key function in implementing risk management (Allegrini and D'Onza, 2003; Gramling and Myers, 2006; Lenz and Hahn, 2015; Nagy and Cenker, 2002; Sarens and Beelde, 2006). Goodwin and Kent (2006); Leung *et al.*, (2003) also found an increasing frequency of usage of the internal audit function in the integrated risk management framework among Australian companies. In addition**,** Griffith (1999) uncovered that the financial directors of 200 US companies believed that internal audit operations should extend to risk management and required qualified internal auditors.

2.3.3.2. Control

Glossary of the IIA (2013, p. 42) provides the meaning of control as follows:

> [a]ny action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

The systems of internal control are extremely important for the internal administration of organisations since the systems aim (Wolnizer, 1995, p. 57):

> ... to safeguard the property of the firm, to establish levels of accountability and authority, to differentiate between areas of functional responsibility, to increase the likelihood that the policies and procedures prescribed by managers are implemented and followed and to provide documentation of the commercial affairs of firms".

The scope of controls refers to the Standards of Internal Auditing cover as follow:

> …the adequacy and effectiveness of controls in responding to risks within the organi[s]ation's governance, operations, and information systems regarding the achievement of the organi[s]ation's strategic objectives, reliability and integrity of financial and operational information, effectiveness and efficiency of operations and program[me]s, safeguarding of assets, and compliance with laws, regulations, policies, procedures, and contracts (IIA, 2013, p.32).

A number of scholars classify the internal control system into financial accounting and operational controls (Dittenhofer, 2001b ; Shaub and Brown, 1994). According to Sawyer and Vinten (1996), there are different objectives of internal audits for these two systems of internal controls. Sawyer and Vinten (1996) further explain that in terms of financial accounting controls, internal auditors investigate the internal controls support to validate the financial statement. In respect to operational controls, the internal auditors examine the internal controls which intend to strengthen the operational system, as well as ensure the operations are aligned with the expectations of senior management and the audit committee. The effectiveness of control systems is one of the main goals of the internal audit work together with assets protection, and accuracy of reporting systems (Wagonner and Ricketts, 1989).

The basic reasons for financial auditing and operational auditing also differ. The auditing of an operational control mostly stems from the demand within an organisation, whilst auditing of the financial accounting control refers to requirements from outside the organisation, such as shareholders, banks, and the government (Spraakman, 1997). In the context of internal audit over financial accounting control, Sherer and Kent (1983) consider internal auditing as "a bonding cost borne by the senior managers to satisfy the demands for accountability made by external participants, especially shareholders" (p.99). In this case, internal auditing acts as an adjunct function of the external audit. The growth of the internal audit function which is presented in previous sections indicates that the requirements from government regulations and professional bodies contribute to the functions of internal auditing in respect of the control system.

Internal auditing is also a feedback mechanism which allows management to remedy any process which may have significant effects on the internal control system of the company and its financial condition (Sherer and Kent, 1983). Similarly, other scholars point out that managers' need for information relating to economising could be provided by internal auditing since all operational and financial information can be pursued by the internal auditors (Williamson, 1985) and they can discover problems at an early stage (Xiangdong, 1997). Therefore, internal control systems need to be evaluated by the internal audit function to meet the expectation of the internal and external parties of an organisation in terms of its effectiveness (Ditternhofer, 2001b), and to assist organisations meet all its objectives (Whittington and Pany, 2008). Besides, the assessment of internal control is important since sound internal controls reduce the risk of producing unreliable financial statements (Wagonner and Ricketts, 1989).

There is a clear relationship between the internal control system and internal auditing, specifically "the internal auditing function[s] as part of the monitoring

component of an organisation’s internal control” (Whittington and Pany, 2008, p. 798). Whittington and Pany (2008) further describe functions concerned with financial controls as well as the entire internal control of organisation. Assessing the internal control system of an organisation is one of the principal functions of internal auditing (Wagonner and Ricketts, 1989). The evolution of internal audit functions proves that the internal auditing has been recognised and used as an important control technique (Thurston, 1950).

Professional bodies also stress the function of internal audit to evaluate and maintain the effectiveness of an internal control system. For instance, COSO (1994) highlights the important role of internal auditors to monitor the effectiveness of internal control systems as a consequence of their position and authority in an organisation. It is also mentioned that the internal control system is dynamic and varies between organisations and always changes depending on the internal and external environment of the entity (COSO, 1994). Further, the alteration of the internal control system in an organisation will affect the internal audit function. For example, the system of internal control has changed from manual to computerised systems. This transformation influenced the auditing process, skills of the internal auditors, time needed to complete the audit and other related aspects. Due to the dynamic nature of internal control systems, COSO (1994) gives the recommendation that the control system should be evaluated by the internal auditor to assure its effectiveness. COSO's statement is also supported by the IIA as the profession organisation of the internal auditor. The IIA (2013) states that the internal and external environments of a firm vary in aspects, such as the purpose, size, complexity and structure, as well as in legal and cultural environments which may require different applications of internal control systems.

Therefore, the IIA released the Internal Auditing Standards as guidance for internal auditing work, specifically to evaluate the effectiveness of internal control systems.

The internal auditors are required report on the effectiveness of the entire control system and also determine whether the control system is adequate to meet management's needs by conducting more detailed testing and review of certain business activities (Vanasco *et al.*, 1995). There were four major purposes of internal control reporting as suggested by Brink and Witt (1982), which consisted of providing findings and conclusions, determining the areas needing improvement, giving recommendations for correcting deficiencies, improving operations and as a basis for taking improvement actions.

2.3.3.3. Governance

A number of financial reporting scandals prompt the need to improve corporate governance (Gramling *et al.*, 2004). In this case, the internal audit function is expected to improve corporate governance by overcoming the failure in the systems of business reporting, internal control as well as ethical behaviour (Bailey *et al.*, 2003). This expectation is reflected in the guidance, regulations and various best practices articles that underline the relationship between qualified internal auditors and parties who are responsible for maintaining good corporate governance (Gramling *et al.*, 2004). The IIA also responds the condition of business environment by incorporating corporate governance as one of scopes of the internal audit activities. This is contained in the definition of internal auditing as well as in the Standards of Internal Auditing issued by IIA. Moreover, the glossary of the IIA (2013) provides the meaning of governance as follows:

> [t]he combination of processes and structures implemented by the board to inform, direct, manage and monitor the activities of the organi[s]ation toward the achievement of its objectives (p.43).

Gramling *et al.*, (2004) define corporate governance as “the procedures and activities employed by the representatives of an organisation’s stakeholders to provide oversight of risk and control processes administered by management” (p.195).

In terms of components of corporate governance, there are different outlooks among the scholars. Gramling *et al.* (2004) explain that management, the audit committee, the external auditor and the internal audit unit are the main actors involved in corporate governance. In this case, the internal audit department is a resource for the other three parties responsible for corporate governance (Rittenberg *et al.*, 1999; Ruud, 2003). Therefore, the quality of the internal audit function will determine its nature and value as a resource (Gramling *et al.*, 2004). Other scholars, Ridley and Chambers (1998) define ethics, accountability to owners, creditors, workers, authorities and the public-at-large as broader elements of corporate governance which demand sound financial and operational control over the activities of business organisations. Ridley and Chambers (1998) further state that these parties believe that an effective internal control system can create and retain good corporate governance since the system could prevent the problems. The system includes financial and operational control over the activities of the enterprise (Ridley and Chambers, 1998).

Assuring an effective control system calls for competent and qualified internal auditors (Ridley and Chambers, 1998). Nonetheless, if management refuses to be monitored by the internal auditor then the result will be ineffective monitoring (Cohen *et al*., 2008). In terms of the audit committee, independent members of the audit committee create a strong relationship between the internal auditor and the audit committee (Goodwin and Yeo, 2001) in which it may assist the internal auditors to implement good corporate governance. Furthermore, professional bodies, such as IIA

(1989) also include internal auditing as an important factor in the process of corporate governance and integrity, such as the process of financial reporting.

Internal auditors may improve the governance process by preventing financial reporting irregularities and employee theft (Christ *et al*. 2015; Hansen, 1997; Prawitt *et al*., 2009; Schneider and Wilner, 1990), and by improving the quality of risk management and internal control processes (Lin *et al*. 2011; Sarens, 2009) and by preventing management misconduct (Ege, 2015; Prawitt *et al*., 2012). These in turn result in increasing the performance of the company (Gordon and Smith, 1992). The IIA (2013) provides guidance for the internal auditor to improve the governance process by undertaking a number of actions as follow:

> [p]romoting appropriate ethics and values within the organi[s]ation; ensuring effective organi[s]ational performance management and accountability, communicating risk and control information to appropriate areas of the organi[s]ation; and coordinating the activities of and communicating information among the board, external and internal auditors, and management (IIA, 2013, p. 29).

In addition, the internal auditor is also expected to handle whistle-blowing matters as the auditor has more opportunities to report negative information to top management and has a more powerful position than others (Near and Miceli, 1985). The powerful position of internal auditor is also supported by the awareness of senior management of the important role of the internal audit function in the governance process (Carcello *et al*., 2005). The consciousness of management is indicated by demanding the internal auditors to put strict attention to Standards (Carcello *et al.*, 2005). Thus, internal auditing contributes significantly in assuring good governance (Griffiths, 1999), particularly in improving the quality of corporate governance. While the relationship between internal auditing and the audit committee is important, management and external auditors also have a role in improving the governance process (Antoine, 2004; Gramling *et al.*, 2004). However, this argument is in disagreement with other scholars

(Churchill and Cooper, 1965; Ebaid, 2011; Uecker, *et al.*, 1981) who state that the activities of internal audit do not affect to corporate governance.

The areas of risk management, control and governance process are within the scope of work of an internal audit, and are improved by undertaking assurance and consulting activities. These activities are conducted through an audit process which is presented in the next subsection.

2.3.4. The Performance of the Audit Work

The internal audit activities should be performed with a systematic and disciplined approach as presented in the definition of internal auditing (IIA, 2013). A systematic process of auditing consists of a number of steps, namely audit planning, examining and evaluating information from fieldwork, reporting findings and following up the audit recommendations (IIA, 2013). These stages are general guidelines provided by the Standards for the internal auditors to carry out the auditing activities. Similarly, Sawyer *et al.* (2003) states that internal auditors should follow the Standards by performing a number of actions. Firstly, the head of internal audit department must supervise the entire auditing process, from planning to completion. Secondly, all the audit works should be documented in the audit working papers including the evidence of follow-up procedures and disposition of deficiency findings. Thirdly, the conclusions drawn within the audit reports should be backed by comprehensive supporting documents and also competent, sufficient, and relevant evidence. Finally, there should be an archival system for the working papers. It is important to plan, control and record the work of internal audits, and internal auditors may use these processes to determine audit priorities, set objectives and audit resources (William *et al.,* 2001).

Planning activity covers specifying the areas to be audited (Ramadan, 1997), developing the audit programmes (Haron *et al*., 2004), supervising internal audit staff

(Beale and Bradford, 1993), and setting audit objectives, scope, timing and resource allocations (IIA, 2013). Furthermore, the IIA (2013) recommends internal auditors consider a number of matters in the audit planning process as follow:

- [t]he objectives of the activity being reviewed and the means by which the activity controls its performance;
- [t]he significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level;
- [t]he adequacy and effectiveness of the activity's governance, risk management, and control processes compared to a relevant framework or model; and
- [t]he opportunities for making significant improvements to the activity's governance, risk management, and control processes (p.32-33).

An annual audit plan should be reviewed by the audit committee together with the chief internal auditor and the independent public accountant (Treadway, 1987). A number of studies emphasise the relationship between the internal audit plan and management. Cooper *et al.* (1994) found that senior management were willing to intervene an internal audit plan. This attitude meant senior management may limit the internal audit functions, by asking the internal auditor to only perform traditional duties (Galloway, 1995). However, Doyon (1996) and Hubbard (2000) suggested that the Chief Audit Executive (CAE) could talk to management and determine what management is concerned about in terms of risky business activities. The audit plan is undertaken by the internal auditor by collecting data from the auditee as a person or organisation unit that is audited. The data collected from this fieldwork audit then is recorded in the working papers as evidence in preparing the audit reports (Ratliff *et al*., 1988). The IIA (2013) encourages the internal auditors to identify, evaluate and document sufficient information to meet the audit objectives when they carry out the audit plan. Ratliff *et al*. (1988) describe the benefit of a working paper as consisting of a source of information for following audits and to evaluate the performance of all members of the internal auditor team.

The audit reports should be delivered to a higher level than the CFO in order to ensure an effective implementation of audit recommendations (Brierley *et al*., 2001). The audit reports should also be given to the highest level of management since they are a main factor underlying effective internal audit work (Cosserat and Rodda, 2009). Chambers and Odar (2015, p.43) stated that "to be a reliable provider of assurance to the board, internal audit needs to report for all purposes, including 'pay and rations', to the board or to a chairman of the board". The IIA (2013) recommends that audit reports should specify its scope and contain the objectives, the applicable conclusions, recommendations and action plans which ought to be reported to senior management and the board of directors.

The criteria for a successful audit consist of the auditee considering the audit findings, and following up the audit recommendations (Courtemanche, 1986). Therefore, the IIA (2013) recommends the chief audit executive to "establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action" (p.40-41). However, Courtemanche (1986) argues that organisational status contributes to how easy it is to obtain proper responses from the auditee, but not from senior management and the board. In this respect, "[t]hey may or may not 'respond' to the findings and they may or may not accept the auditors' recommendations" (Courtemanche, 1986, p.43). The attitude to ignore the audit recommendations could be caused by the perception among management that internal auditing is a barrier to achieving organisational goals and in this case such a perception may be detrimental to the company (Flesher and Zanzig, 2000).

2.3.5. Managing the Internal Audit Department

The Standards require the head of the internal audit unit to manage the internal audit department effectively. Likewise, the literature underlines a number of important items to be considered in managing the internal audit unit, such as the internal audit charter, recruitment of internal auditors, career of the internal auditors, relationship between the internal auditor and the audit committee as well as external auditors, and the Quality Assurance Review.

2.3.5.1. The Internal Audit Charter

The IIA (2013) defines the internal audit charter as:

> …a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organi[s]ation; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities (p. 42).

The internal audit charter endorsed by the entity's management is an essential foundation for the internal audit department to achieve its objectives (Burnaby *et al.*, 1994). Therefore, the charter must be approved by the senior management and the board of directors as recommended by the Internal Audit Standards No 1000 (IIA, 2013). The charter also needs to be reviewed periodically (IIA, 2013). The approval is an indication of management support of the internal audit functions (Burnaby *et al.*, 1994). However, the understanding of the importance of the charter is varies across different countries. This is revealed in a study by Burnaby *et al.* (1994) that found that India and Italy have an internal audit charter, whilst Japan has no charter to guide the activities of internal audit departments, and neither the UK nor Australia place much importance on the charter. Burnaby *et al.* (1994) concluded that "... without legal requirements to adhere to IIA Standards, the need for formalization through a charter of the internal audit department's responsibilities is not determined to be important" (p. 253).

2.3.5.2. Recruitment of Internal Auditor

The number of internal auditors should be balanced with the internal audit activities, so that they are able to complete all of their duties. Moreover, the number and qualifications of internal auditors has a relationship with the effectiveness of the internal audit department (Steam and Impey, 1990). In this case, the head of the internal audit department should complement the expertise properly by recruiting personnel who can demonstrate knowledge and skill in all disciplines (Colbert, 2002). Furthermore, Steam and Impey (1990) suggested that the recruitment process of an internal auditor should consider three main categories. First, the internal audit department should determine job descriptions of each position and the scope of work including its responsibilities. Second, the audit unit ought to set requirements of professional qualifications for all levels of internal auditors, such as educational background, on-the-job training, skills and abilities. Third, the unit of internal audit has to decide the kinds of experiences required to be fulfilled by the internal auditors, such as organisational, professional, management, as well as clerical and administration.

Moreover, Engle (1999) suggested that the competence of an internal auditor should be placed as one of the top priorities of organisation since competent internal auditors are able to provide effective auditing that brings benefits, such as contributing to the achievement of organisational goals, reducing the cost of external audits, as well as reducing any disagreement between the external auditors and management over the application of accounting principles.

2.3.5.3. Career of Internal Auditor

Ratliff *et al.* (1988) explain that the internal audit department divides the career structure of internal auditor into four levels: directors, managers, senior and junior auditors. They further explain that the director is responsible for the entire activity of an

internal audit department, such as formulating planning, policy and procedures of auditing, managing the internal auditors, coordinating with external auditors in terms of the audit work, communicating with the board of directors and audit committee, and establishing an audit quality programme. The managers of internal audit tackle audit planning, the auditing works and also coordinate the audit work. The senior auditors are required to supervise the audit work, while the less complex and more routine audit work is the responsibility of the junior auditors

A number of scholars highlight the internal audit unit as a training basis for future managers. The internal audit department is an important step in employees' careers since it provides a training ground for promotion to other management positions (Cooper *et al*., 1996). However, using the internal audit department as a potential pool of management talent endangers the objectivity of internal auditors (Koonce, 2013; Rose *et al.,* 2013).

2.3.5.4. The Relationship between Internal Auditor and the Audit Committee

The Cadbury Report 1992 and the Smith Report 2003 emphasise the audit committee as an important aspect of corporate governance. Moreover, both Reports provide guidance on roles and responsibilities of the audit committees. It is suggested that the audit committee's members comprise at least three non-executive directors within public companies. Furthermore, the Reports state that the audit committee is expected to ensure that the company apply the systems of financial reporting and internal control as well as maintain a suitable relationship with the company's auditors.

Since the audit committee and the internal auditing are cornerstones of good corporate governance, it is important to have an effective working relationship between them. "By strengthening internal audit's relationship with the board, internal audit will be able to provide stronger assurance to the board…" (Chambers and Odar, 2015, p.44).

In this case, the audit committee should monitor and review the works of internal auditors. Referring to the Financial Reporting Council (FRC)'s Guidance on Audit Committee (2008), the following factors should be reviewed by the audit committee:

- ensure that internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee;
- review and assess the annual internal audit work plan;
- receive a report on the results of the internal auditors' work on a periodic basis;
- review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- meet with the head of internal audit at least once a year without the presence of management; and
- monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system (p.11).

Similarly, the audit committee can increase the quality of internal audit functions by opening lines of communication and holding an independent forum to discuss sensitive issues, specifically matters affecting management raised by internal auditors (Braiotta, 2004; Goodwin and Yeo, 2001). The audit committee can also provide internal auditors with regular and confidential access to the committee (BRC, 1999). On the other hand, the internal auditors can assist the audit committee in undertaking oversight on reporting and risk management control (Bishop *et al*., 2000), and to overcome the problem of information asymmetry since the audit committee has no direct access to the same level of information as management (Bishop *et al.*, 2000; Raghunandan *et al.*, 1998, 2001).

A number of scholars concluded that sound corporate governance required a good relationship between the audit committee and internal auditors (Bishop *et al.*, 2000; Scarbrough *et al.*, 1998). Arena and Azzone (2009) found that periodic meetings between the chief audit executive and audit committee, and also the level of monitoring and reviewing the internal audit works by the audit committee were significantly correlated with the effectiveness of internal auditing. In contrast, Nagy and Cenker

(2002) discovered cases where even though the chairman of the audit committee and the internal audit director had a strong communication channel, none of the directors assisted the audit committee to do financial reporting oversight. George (2005) highlights cases of public sector organisations in the US that have no audit committee with the result of a number of failures in the public sector and shortcomings of government audits. George then calls on urges to the US Government Accountability Office (GAO) to introduce audit committees in public sector organisations as a means to achieve effective financial oversight. In addition, Al-Twaijry *et al.* (2002) revealed that audit committees in the corporate sector in Saudi Arabia faced problems, such as unqualified members, lack of independence, and poor relationships with internal auditors.

2.3.5.5. The Relationship between Internal Auditor and the External Auditor

Internal auditing can contribute added value to an organisation by aiding good cooperation with external auditors who perform an independent auditing. Both external and internal auditors have to ensure the effectiveness of internal control systems and have to examine the financial reporting process (Wagonner and Ricketts, 1989). Wagonner and Ricketts (1989) further describe that the effective internal controls lessen the risk of producing unreliable financial statements. Since internal auditors examine the entire control systems as well as the financial reporting functions on an in-depth and continuous basis (Edge and Farley, 1991), they have better understanding of the systems (Braiotta and Marsh, 1992).

Some studies have found benefits are obtained from the cooperation between internal and the external auditors, such as reducing the external audit fees (Messier and Schneider, 1988; Wagonner and Ricketts, 1989; Wallace, 1984), and improving the efficiency and effectiveness of the audit process (Gaston, 2000; Sawyer *et al*., 2003).

Lowering the external audit fees could be achieved by number of mechanisms. For example, the external auditor can use internal audit's reports in evaluating the adequacy and effectiveness of control systems which are directly related to the production of financial statements (Munro and Stewart, 2008; Wagonner and Ricketts, 1989). Also, the internal auditors may provide assistance, such as organisational support, reviewing, testing, as well as preparation and drafting of footnotes to the financial statements to external auditors (Wallace, 1984). Similarly, Messier and Schneider (1988) suggested that minimising external audit costs can be achieved through integrating external and internal audit plans and providing internal audit assistance, audit rotation of major locations, external auditor acceptance of internal audit work, and audit work performance of internal auditors under external auditors' supervision. However, if there is a lack of co-ordination between the internal and external auditors, then efficiency will be lost due to duplication (Sawyer *et al*., 2003), and there is the possibility of errors occurring (Gaston, 2000).

Nonetheless, cooperation between the internal and external auditors can be realised if the internal auditors meet certain criteria set by the AICPA. AICPA issued the Statement on Auditing Standards (SAS) No. 9 as a guideline for external auditors to consider the competence, objectivity and work of the internal auditors before deciding whether to rely on it or not (Messier and Schneider, 1988). Nevertheless, a number of studies found that the external auditors use different factors as consideration of whether to rely on internal auditors' work, such as a high level of competence and work performance (Margheim, 1986), the internal auditors' involvement in consultancy activities regarding the financial reporting system, relationship with the audit committee, as well as the risk and control environment (Munro and Stewart, 2008).

2.3.5.6. Quality Assurance Review

A quality assurance activity is crucial as it ensures high-quality internal audit function work (DeSimone and Abdolmohammadi, 2016; Lin *et al.*, 2011). The Standards No 1300 require the chief audit executive to carry out a quality assurance programme which covers all aspects of internal audit activity (IIA, 2013). This programme includes both internal and external assessments (IIA, 2013). Chambers and Odar (2015) describe best practice for conducting internal assessment to the internal audit as follow:

> a large internal audit function should have a dedicated, independent unit to undertake internal quality assessment reviews of the internal audit function, or at least these reviews should be undertaken by internal auditors who had no part in the audit engagements being reviewed" (p.48).

In terms of the external assessment, it is recommended it is performed at least once every five years by a qualified and independent reviewer (IIA, 2013). This programme aims to maintain the quality of the internal audit practice (Huston and Warrick, 1993). Therefore, lack of practice of external review may imperil continuing development of the profession or in other words, "the external review is a professional imperative" (Huston and Warrick, 1993, p. 559).

A survey of Fortune 1000 companies in 1986 showed that there were a number of benefits of conducting the external review, listed below (Huston and Warrick, 1993, p. 555):

- ... provide assurances to senior management and the audit committee that the department is in compliance with the Standards, targeted problems and presented sound recommendations, and provided an independent, objective review of the department.
- ... provide internal auditors with an opportunity to exchange ideas with others outside of the organisation, help management in allocating resources to the internal audit function, and help to evaluate the performance of the director of internal audit.

However, in a number of cases, internal audit departments did not perform the external review program as recommended by the IIA since the criteria of the review was not mandatory (Huston and Warrick, 1993). In these cases, they replaced the external review with carrying out the supervision or internal review processes (Huston and Warrick, 1993).

This section describes the concept of internal auditing, the functions of internal auditing and also the important nature of internal auditing. The nature of internal auditing comprises independence, proficiency, the scope of work, performance of audit work and managing of the internal audit department. The nature is derived from the IIA as international profession organisation of internal auditor and supported by the literature. This section provided a conceptual basis of internal auditing with a few examples of empirical research; the practice of internal audit is presented in the next section.

2.4. The Practice of Internal Auditing

As presented in the previous section, the practice of internal audit function may be influenced by the environment where it operates. Since conditions in every country are different and government regulations and the implementation of the Standards of Internal Auditing may differ, the practice of internal auditing worldwide could be diverse. There are two kinds of studies focused on the practice of internal auditing. First, there are studies that examined the environment and its influence on the internal audit practice without using any particular theory as a framework. Second, there are studies that use institutional theory to investigate the environment and its effect on the practice of internal auditing.

Many studies focus on the effect of the environment on the internal audit practice without using theory as a research framework. These studies were conducted in

different countries, such as in the US, Europe, Malaysia, China, and India. In the US, Thurston (1950) found that the formation of the Institute of Internal Auditors in 1940 resulted in the establishment of internal audit departments by fifty per cent of manufacturing companies in the study. Similarly, Wallace and Kreutzfeldt (1991) discovered that the recommendations issued by the Report of the National Commission on Fraudulent Financial Reporting and the Treadway Commission's report on maintenance of an effective internal audit function had an impact on the formation of internal audit departments in a substantial number of companies. However, Burnaby *et al.* (1994) found practices of internal auditing in many countries varied since there were different legal and economic environments in each country. They further explained that internal auditing is strongly supported by government regulations in US, Canada, Israel, and India, but not in Australia, or Japan. In terms of the implementation of the Standards of Internal Auditing issued by the IIA, they found that 82% of the internal audit departments followed the IIA Standards, while 16% of them did not. In addition, they found that IIA chapters contribute to development of internal auditing in companies in some countries, such as France, and New Zealand.

The IIA (1991) conducted a study on the practice of internal auditing in several countries: Spain, China, India and Malaysia. In Spain, the IIA (1991) found a lack of institutional regulatory or legal background. However, Spain's Institute of Internal Auditors had gradually influenced the business life of the country. This is indicated by the presence of internal audit departments in almost all important organisations. Furthermore, the internal audit has expanded its functions beyond the instrument of control and fraud prevention, and is considered more as a management function in the company (IIA, 1991). Nonetheless, IIA (1991) also revealed that in Spain there was lack of awareness of the internal auditing function in general, and auditors were also lacking

in professionalism. Nor was there a reliable indicator of the competence of internal auditors, such as professional certification. Also, the failure to communicate the modern concept of the internal audit function within organisations had an impact on the internal audit image, and resulted in a communication gap between management and audit departments (IIA, 1991; Vanasco *et al.*, 1995).

In China, internal auditing obtained strong support from the government regulations. China's Regulation No 5 states that "the audit bureau can establish internal audit departments or can assign auditors to perform internal audit functions in governmental audits or enterprises" (Vanasco, *et al.*, 1995, p. 35). This legislation influenced the establishment of internal audit in China. The regulation defined the scope of internal audit activities, which encompassed auditing of financial income and expense, economic effect and economic responsibility (IIA, 1991). Similarly, India has a strong legislative environment. The Indian Companies Act of 1956, amended in 1976, required independent auditors to provide an opinion on the adequacy and efficiency of internal audits in all medium and large companies (IIA, 1991). This legislation prompted the growth of the internal audit function. The requirement of an effective internal auditing was applied to all public and private companies (IIA, 1991, Vanasco *et al.*, 1995). However, since the 1950s, internal auditing was mainly found in financial institutions. In these institutions, the internal auditors reported directly to top management and the audit committee (IIA, 1991; Vanasco, *et al.*, 1995). Similarly, IIA-India played a role in the business environment by processing corporate membership for large corporations in government and private sectors and holding seminars and workshops for the banking and insurance sectors (IIA, 1991; Vanasco, *et al.*, 1995). However, envy on the part of the Institute of Chartered Accountants concerning the

growth of IIA-India had a negative effect on the numbers of professionals who wished to have a CIA certificate (IIA, 1991; Vanasco, *et al.*, 1995).

In contrast, although there was no legal support for internal auditing in Malaysia; the IIA-Malaysia was established in 1977. But despite this, the internal auditing has not been fully accepted as a profession. This has impacted on many problems facing the internal auditing profession. Internal auditing was perceived as a checking function rather than a management control, resulting in a presumption that internal auditing was a complementary function of financial and accounting activities (IIA, 1991; Vanasco, *et al.*, 1995). Moreover, the internal auditing was lacking management support, a fact indicated by the resource constraints of internal auditing (IIA, 1991; Vanasco, *et al.*, 1995). This was reflected in the small size of internal audit departments compared to their activities in most institutions. Also, there was no management policy on the internal auditing causing the internal auditors were lack of authority and direction. These conditions meant the activities of internal audits were largely ineffective. In terms of competence, internal auditors were mainly accountants who had accounting as their educational background. They were also lacking in education and training provided by their organisations and in career opportunities. In Malaysia most of the internal auditors are not members of the IIA Malaysia. Nonetheless, organisations such as banks and other financial institutions with strong internal audits, also have an audit committee.

A number of studies on internal auditing have been conducted in Europe. Paape *et al.* (2003) found that corporate governance regulations had no significant impact on the practice of internal auditing, demonstrated by the fact that not all public companies possessed an internal audit department. Also, not all Chief Audit Executives (CAE) were aware of corporate governance regulations. In addition, some CAE believed that they were not required to comply with the Standards of Internal Audit issued by IIA, a

belief which may effect the quality of internal audit activities provided by the internal auditor. However, in terms of scope of internal audit activity, the units have been followed the Standards. This was demonstrated by the assurance services, such as operational audit, information technology audit, financial audit and also consulting services provided by the audit units. Burnaby *et al.* (2009) discovered that the presence of European Corporate Governance Codes had an effect on the establishment of internal audit unit only in financial companies, because it was voluntary for non-financial companies. In contrast, the Netherlands has no regulations on internal auditing, but many large Dutch multinationals have large audit units. The scope of internal auditing expanded from financial and compliance audits to audits of operational, Electronic Data Processing (EDP), working conditions, and quality. The scope of audit activity also covered a review of internal controls focused on financial audits (Vanasco, *et al.*, 1995).

Roth (2002) found that SOX 2002 created significant impacts on the internal audit practice. First, SOX 2002 changed the emphasis of internal auditing services from detection to prevention. Second, the mindset of internal auditors changed from confrontational to partnering with management. Third, the internal audit approach switched from a control- to a risk-based approach. Fourth, the services of internal audits became centred on consulting activities. Fifth, there was an understanding of the important function of internal audits and organisational goals.

Allegrini *et al.* (2006) conducted a study in France and found that French law and SOX (2002) affected the internal audit activities by concentrating more on reviewing the internal control of financial reporting systems and undertaking compliance audits. The auditors also carried out consulting activities by providing recommendations on specific projects or working teams. Also, the auditors used risk-based audits as a new approach. In Italy, Allegrini and Bandettini (2006) found that the definition of internal

auditing issued by the IIA and the Italian Law on the internal control system had an impact on the activities of internal audit functions. This is demonstrated by the fact that internal auditors provide more time on consulting activities, particularly in relation to corporate governance and risk management.

Vanasco *et al.*, (1995) and Vinten (1991) found that regulations in the UK and the US created divergence in the practice of internal auditing in American and English corporations. The differences emerged since UK had the internal control guidance issued by the Cadbury Committee Working Group on Internal Control in 1994 which was not supported by the legal environment, while the US has had a strong legal environment for internal control since the US has FCPA issued in 1977 (Vanasco, *et al.*, 1995; Vinten, 1991). However, this study did not provide a detailed explanation on this divergence matter.

Goodwin-Stewart *et al.* (2006) conducted a study in Australia in 2000 and discovered that lack of a legal requirement to have an internal audit function for public companies resulted in majority of public companies in Australia having no internal audit unit. In addition, the public companies that have established an internal audit unit have only one or two internal audit staff. Likewise, Carey *et al.*, (2000) also discovered that the Australia Stock Exchange (ASX) does not mandate to all public companies to have an internal audit function so that in general, there is an absence of internal audit functions within companies.

Hass *et al.* (2006) highlight that SOX (2002) legislation created a number of negative impacts on the practice of internal auditing in the US. First, many internal audit units used too many resources to perform compliance audits to SOX (2002) and less for operational audits and consulting activities (PwC, 2005). Second, an emphasis on assurance services could result internal auditors being seen negatively as ‘a police’

(Gray, 2004) which may decrease the effectiveness of the internal audit function in its assurance and consulting activities (Hass *et al.*, 2006). Third, the internal auditors need to work closely with management and external auditors as a consequence of regulatory requirements which could damage the independence and objectivity of the internal auditors (Krell, 2005).

In addition, Nagy and Cenker (2002) found that the IIA as a professional organisation of internal auditors failed to influence the practice of internal audit in the US. This is indicated by the belief of directors of internal audit that the IIA only responsibility was to provide the audit guidance and it was up to top management to determine the tasks of the internal auditor. This belief resulted in the absence of changes in the internal audit function in most companies.

Cooper and Craig (1983) found that in Australia the internal auditor had no professional body and no generally accepted professional qualification. This condition created an expectation gap between the internal auditor and the CEO. The activities of internal audits focused on financial audits while the CEO expected the internal auditor to perform beyond it. Cooper *et al.* (1996) found that in the late 1990s, in China, regulation and culture impacted on internal audit activities. Internal auditing in China was an agent of the state and all of the activities of internal audit were supervised by the Audit Administration of the Peoples Republic of China (AAPRC). Under the Law of China, the activities of internal audit institutions covered auditing of financial revenues and expenditures, economic contracts, construction projects, internal control, economic responsibility, maintenance of assets, economic laws and regulations, and operational budgets. The business culture in China is that trust must be set up before conducting business by the exchange of gifts and favours (Hwang and Staley, 2005) - a practice which may impair the independence and objectivity of the internal auditor.

Ernst and Young (2005) found that the Australian Securities Exchange (ASX) principles of corporate governance had an impact on the internal auditing practice in public companies in Australia and New Zealand. In this case, the internal audit function concentrated on testing of internal control, and provided assurance on risk management. Burnaby *et al.*, (2009) found a different level of implementation of the Internal Auditing Standards between US and a number of European countries, such as Belgium, Italy, the Netherlands, the UK and Ireland. This occurred since the management and the board believed that compliance with the Standards was not adding value, it was too time-consuming, and there were no adequate internal auditors (Burnaby *et al.*, 2009). As a result, there were significant levels of variation between countries in terms of educational degrees and professional certification of the internal auditors.

Burnaby *et al*. (1994) found that the Standards issued by the IIA created an effect on the internal audit functions, which mostly focused on a review of financial and operating information. Less than half of respondents audited the construction projects, corporate ethics, manufacturing and production control, marketing, quality control, research and development, and transfer pricing. In terms of audit reporting, the respondents mostly reported to the CEO. However, only a quarter of respondents reported to the audit committee and half of respondents met with the board once a year. 28% of the participants had meetings with audit committee four times a year. Thus, Burnaby *et al.* (1994) inferred that only 82% of internal auditors complied with Internal Auditing Standards.

The studies above indicate that the presence of legislation and Standards create diverse impacts on internal audit practices in a number of countries. However, the studies did not address details on how or why the response of internal auditors towards the legislation or the Standards could shape the practice of internal auditing. Therefore,

the extent of the effect of legislation and Standards on the internal audit practice is not clear. Meanwhile, there are few studies that use the institutional theory to investigate the influence of the institutional environment on the practice of internal audit. According to the theory, the institution's environment consists of three kinds of pressures; coercive (government regulation), normative (the professional bodies) and mimetic (business uncertainty).

Al-Twaijry *et al.* (2003) by using the institutional theory found that there was no legislative support to internal auditing in Saudi Arabia which then resulted in the closure of the IIA chapter of Saudi Arabia. In addition, the IIA failed to influence the practice of internal audit which was demonstrated by the fact that internal audit units were not established in the majority of the companies. Other companies that had internal audit units had not fully implemented the Standards. The study of Al-Twaijry *et al.* (2003) examines the internal audit practice by comparing the recommendations of the Standards of Internal Auditing and responses of the internal audit units. In this case, they use a survey and interview the directors of internal audit units.

Similarly, Arena *et al.* (2006) and Arena and Azzone (2007) found that there was no specific Italian regulations on the practice of internal auditing. However, there was Italian legislation on the internal control system which had an impact on the establishment of internal audit unit and the practice of internal auditing in Italy. Arena *et al.* (2006) and Arena and Azzone (2007) also compared the requirements from the institutions' environment and the internal auditors' responses in practice by interviewing the directors of internal audit units. The study of Arena *et al.* (2006) and Arena and Azzone (2007) confirmed the relevance of institutional pressures on the internal audit practice.

Mihret *et al.* (2012) discovered there was government support for internal auditing in Ethiopia by providing regulations and supporting the establishment of the IIA-Ethiopia Institute. Mihret *et al.* (2012) explored the practice of internal audits in the public sector and private companies by investigating the pressures from the institutional environment (coercive, normative and mimetic) and the responses of the internal auditors. By undertaking interviews with the directors of internal audit units, they discovered the pressures that influenced the practice of internal auditing in Ethiopia.

Elbardan *et al.* (2015, 2016) used institutional theory to investigating internal audit function adaptation to the new Enterprise Resource Planning (ERP) systems implementation in the corporate governance's institutional pressures context. Elbardan *et al.* (2015, 2016) found that the internal audit function is changed in a number of aspects, such as auditing tasks, time and effort needed to carry out audit activities, structure of the internal audit function, internal auditors' skills, tools, relationship with information technology (IT) department, size of the internal audit function, budget for the internal audit function and relation with external auditor.

The studies above investigate the influence of institutional pressures on the practice of internal auditing. These studies involved directors of internal audit units as participants who described the responses of internal audit units toward the pressures. In this case, the studies only focused on upper management level and ignored the activities and experiences of the middle and bottom levels of internal auditors which may create an incomplete picture of the internal audit practice in the companies. Another gap in the literature is that in none of these studies examined the responses of the internal audit unit toward the institutional pressures by confirming the practice to Internal Audit Charter. As the internal audit charter is a legal basis for internal auditors in conducting their duties (Adam, 1994; Burnaby, 1994; Courtemanche, 1986, and Hughes, 2004);

therefore, it is important to investigate the responses of the internal audit unit toward the pressures on internal audit charter as well as examine the implementation of the charter in practice as suggested by Fogarty (1996). Therefore, this study will fill the gap in literature by investigating the adoption of pressures in the internal audit charter, and the implementation of the charter in practice. In addition, in order to obtain a complete picture of the internal audit practice, the study will involve all level of internal auditors in the internal audit unit.

As presented in the previous section internal auditing is socially constructed, and has a similar basic tenet with institutional theory, therefore this study will use institutional theory as the research framework. The institutional theory is presented in the following section.

2.5. Theoretical framework

2.5.1. Justification for Using Institutional Theory

Institutional theories of organisations offer a rich, complex view of organisations (Zucker, 1987) and can be used to study the practice of internal audit functions. The practice is a part of organisational phenomena which could be explained by new institutional theory. This is indicated by prior studies which suggest that new institutional theory is appropriate for explaining the practice of internal audit functions, both in developing countries (Al-Twaijry *et al.*, 2003; Mihret *et al.*, 2010; Mihret, 2012) and developed countries (Arena *et al.*, 2006; Arena and Azzone, 2007). In a similar vein some authors (Ball, 1989; Flint, 1988) have mentioned that internal audit functions are socially constructed and this is consistent with the new institutional theory that holds a view that institutional environment is socially constructed. Therefore, it could be said that new institutional theory is an appropriate theory to be used by this study.

2.5.2. Institutional Theory

Institutional theory illustrates and defines the existence and power which underpin rules, beliefs, values and norms; and those are derived from external interactions. It also assists to provide further explanation of how culture, politics and social forces surrounding entities affect organisational structures and behaviour (Fogarty, 1996). It is also claimed that normative pressures derive from external sources and sometimes arise from within an organisation itself, in turn influencing an organisation's structure (Zucker, 1987). In other words, "how much organi[s]ational structure is shaped by the social environment" (Carruthers, 1995, p. 315). These views perceive a formal organisational structure as "reflections of rationalized institutional rules" (Meyer and Rowan, 1977, p.340) or "shared knowledge of belief systems" (Scott, 1995, p.13). According to Meyer and Rowan (1977, p. 342) formal structure of an organisation is

> a blueprint for activities which includes, first of all, the table of organi[s]ation: a listing of offices, departments, positions, and program[me]s. These elements are linked by explicit goals and policies that make up a rational theory of how, and to what end, activities are to be fitted together.

In addition, Meyer (1978 cited in Fogarty, 1996, p. 249) provides the scope of structure which embraces "the entire social configuration of an activity's domain and is therefore heavily cognitive in nature". According to Fogarty (1996, p. 249), structure contains "the dynamic elements of consent, trust, and the language through which descriptive accounts are given".

It is important to understand two principles of institutional theory. Firstly, the basic belief of the theory is that the institutional environment is socially constructed and affects individual behaviour. Conversely, individual behaviour and action in turn affect the environment. In other words, it is humans who create an institutional environment (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Secondly, organisation from the perceptive of institutional theory is viewed as an open system, which means that

organisational structures and activities are shaped by both the external environment and actors within an organisation (Scott, 1987). Therefore, as Scott (1998) further states the ability to adapt to environmental changes is pivotal to enable organisations to survive.

Maclagan (1998, p.145) proposes that:

> …to survive in the progressively more 'turbulent' social environment…organisations would need to adopt and act according to the values that would align them with the expectations of society.

In addition Scott (1998, p.21) argues:

> every organisation exists in a specific, technological, cultural and social environment to which it must adapt. No organisation is self-sufficient: all depend for survival on types of relations they establish with larger systems of which they are part.

The principles above suggest that organisations need to pay attention to the institutional environment and act in accordance with socially shared beliefs, values and norms. Meyer and Rowan (1977) claim that institutional commands, such as rules and procedures, are commonly incorporated to sustain appearances, since they enable conferring of legitimacy upon the organisation, rather than generating efficient organisational decisions or better outcomes. Accordingly, Scott and Meyer (1983, p.149) believe that organisational contexts are the central view of the institutional theory which are "characterized by the elaboration of rules and requirements to which individual organisations must conform if they are to receive support and legitimacy...". In addition, Oliver (1997, p.700) suggests that:

> the basic premise of institutional theory, then, is that firms' tendencies toward conformity with predominant norms, traditions and social influences in their internal and external environments lead to homogeneity among firms in their structures and activities, and that successful firms are those that gain support and legitimacy by conformity to social pressures.

We can identify these rules, norms, traditions and requirements as institutions. Institutions within an organisational context are viewed as "cognitive, normative, and regulative structures and activities that provide stability and meaning to social

behaviour" (Scott, 1995, p.33). Thus, it is necessary that organisations possess the adaptive ability to institutional pressures so as to avoid external claims of irrationality and negligent behaviour. In addition, the aim of organisational compliance to pressures is to obtain legitimacy and enhance resources for their life prospects. Carruthers (1995, p.317) claimed that:

> being technically efficient is not the only path to organisational survival. Achieving legitimacy in the eyes of the world, state, powerful professions, or society at large, is another effective survival strategy.

In conclusion, the institutional theory acts as a theoretical lens to understand the dynamics of organisational characteristics.

2.5.3. Institutional Theory and Internal Auditing

A number of organisational studies indicated that the institutional theory is useful for understanding behaviours in organisations (DiMaggio and Powell, 1983; DiMaggio and Powell, 1991a; Meyer and Rowans, 1977; Meyer and Scott, 1983; Zucker, 1988). These studies were mostly conducted in public and not-for-profit organisations, such as municipal governments, public agencies, schools and hospitals (Mezias, 1990).

The phenomenon of internal auditing has attracted the interest of a few scholars who have studied it using institutional theory. For example, the studies on the design of the internal audit department and the effectiveness of internal audit (Al-Twaijry *et al.*, 2003; Arena *et al.*, 2006; Arena and Azzone, 2007; Mihret, 2012). However, research on the practice of internal audit in the highly regulated environment of a public SOE in Indonesia is difficult to find.

Internal audit functions are parts of institutional phenomena which are socially constructed by individuals from within and outside organisations. Thus, the institutional theory is relevant to understanding the dynamic of the practice of internal audit functions. Such constructs indicate diverse aspects of behaviour and institutional

environments which affect the practice of internal audit functions. Flint (1988, p.1) contends that:

> audit is a social phenomenon. It has no purpose or value except in its practical usefulness. It is wholly utilitarian. The function has evolved in response to a perceived need of individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged or legitimate interest.

Moreover, Ball (1989) in Seal (1993, p.27) stated that:

> accounting and auditing are institutional phenomena. So it is reasonable to assume that they derive many of their properties from the nature of firms as economic institutions. Progress in understanding accounting and auditing, at all levels of abstraction from board conception of their economic function through to understanding of the reasons for specific accounting and auditing techniques, seems likely to require a theory of the firm that views institutional phenomena as its domain…(quoted by Seal 1993, p.27).

These arguments indicate that internal audit functions should be understood within a framework of institutional theory since it is an institutional practice. According to Schotter (1981), a social institution is regularity in social behaviour which is approved by all of society's members, determines behaviour in specific recurrent situations, and is either self-regulated or regulated by external authorities.

Scapen (1994) argues that organisations could get support from the community and finally gain legitimacy if their existence is based on expectations, norms and beliefs which are judged by society's members. Further, organisations' legitimacy can be obtained when organisations' activities are in tune with norms, rules, and values of their respective institutional environment (DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Mizruchi and Fein, 1999; Scott, 1995). In this case, an SOE in Indonesia attempts to legitimate its activities through the existence of an internal audit unit and its functions. The existence can also play a role as a symbol of an organisation's commitment, particularly by top management, to external values, such as stakeholders' expectation

regarding the effectiveness of a company's controls as a means to obtain the goals of organisation (Adam, 1994).

The arguments above indicate that understanding the organisational contexts within which internal audit functions are operated will lead to a more fruitful study. This can be gained by understanding the interactions of players in an organisation and developing or taking norms, rules, and beliefs to shape the organisation. As mentioned by Neu (1992, p.234):

> [a] social construction perspective provides us with a better understanding of the factors mediating a manager's choices. This approach recognizes that individual institutional and societal relations influence, constrain and even define one's choices, both at point in time and over time. Furthermore, a social construction perspective suggests that some practices are not consciously chosen, rather they are so highly institutionalized that they are taken for granted.

2.5.4. The Origin of Institutional Theory

Institutional theory has its roots in studies of economics, politics and sociology (Scott 1995). The Old Institutional Economics (OIE) emerged as a dissatisfaction response to existing economic theory focusing on a rational economic actor. Veblen introduced OIE through his works in 1889, 1909, and 1919 (quoted by Burns 2000). Gouldner (1954), Parsons (1956), and Selznick (1957) work on the institutional theory, particularly in a sociological context. Old institutional theory describes phenomena in a procedural context and clarifies why and how something has taken place in organisations over time (Burns, 2000). As a result, involving power and politics in describing the occurrence of a process is an essential part of old institutional theory.

Institutional theorists claim that society's members identify organisations through norms and values shared by organisations. In respect to the old institutional theory, Selznick (1957) explains that social norms and values are integrated by organisations into their systems in order to demonstrate their sense of symbolic meanings and to propose an alternative existence in a society despite technical and economic reasons.

The adoption of social norms and values into organisational systems are means for organisations to sustain their behaviour; and this adoption process is called institutionalisation. Selznick (1957, p.16) explains this process as follows:

> It (institutionalism) is something that happens to an organisation over time, reflecting the organisation's own distinctive history, the people who have been in it, the group it embodies and the vested interest they have created and the way it has adapted to its environment.

Within the old institutional theory, the dynamics of organisational factors, such as specialisation and technical design, determines the institutionalisation of beliefs, values and norms (Selznick, 1957). The phenomena of ineffective and obsolete behaviour and actions which is continuously used by certain organisations could be described as the institutionalisation process (Pfeffer, 1981). The institutionalisation of norms and values in organisations occurs when the members of an organisation can be motivated and driven by their leaders to follow the leaders' behaviours. Thus, the leader is "an agent of institutionalisation" (Selznick, 1957, p. 27). The leaders are responsible to ensure that the organisational beliefs, norms, and values are in harmony with social beliefs, values and norms. The institutionalisation of norms and values constitutes the behaviour guidance for the organisational members (Simon, 1957). As a result, the institutionalised rules and procedures of the organisation are reflected in the individual actions and behaviour.

To conclude, the old institutional theory relates to understanding socially accepted values, how the adaptation process occurs in organisations, in terms of the changing of an organisation's culture and structure to conform to social values, and how the values turn into weak and deinstitutionalized (Selznick, 1996). Even though the old institutional theory sees the aspect of external effects, the focus of discussion is centred on the institutionalisation of normative controls such as types of beliefs, norms, and

values (Hirsch and Lounsbury, 1997; Mizruchi, 1999; Scott and Christensen, 1995; Selznick, 1957).

2.5.5. New Institutional Theory

New institutional theory was initiated by Meyer and Rowan (1977), and Zucker (1977) during the mid-1970s. Then, DiMaggio and Powell (1983), and Meyer and Scott (1983) developed and elaborated it further.

A foundation belief of the new institutional theory is that the characteristics of the environment in which the organisation operates determine the structure and behaviour of the organisation (DiMaggio and Powell, 1983; Meyer and Scott, 1983). The organisational practices are influenced by the institutional environment, such as social, political and economic, and also internal institutions including the objectives, structure and culture of the organisation. Obtaining support and legitimacy from the institutional environment are the aims of organisation in adapting with the environment (DiMaggio and Powell, 1983; Meyer and Scott, 1983; Zucker, 1977). Accordingly, organisations are pressured to change their routines by external factors, such as the given socio-cultural norms, relationships among organisations and political pressures by government and other authoritative bodies (Burns and Scapens, 2000; Dacin, 1997; Scott and Christensen, 1995). This condition indicates that "organi[s]ations are embedded in larger systems of relations" which called the "societal sector" (Scott and Meyer, 1991, p. 120). This relates to the group of organisations that provide similar products, services or functions, as well as its major owners, customers, suppliers, competitors, and regulators (Scott and Meyer, 1991).

The system of relations is organised at a broad level, and organisations are related in non-local and vertical hierarchies (DiMaggio and Powell, 1983). As a result, the features and structures of organisation are significantly shaped by how the societal

sector is structured. This happens particularly when organisations are controlled by the structure of decision making, technical or institutional processes, the nature of intern-level controls and the numbers of levels to which organisations have developed (Scott and Meyer, 1991).

The new institutional theory claims that organisations are designed to be obedient to procedures and practices, which are perceived as socially accepted rationalisations, in terms of how to structure the organisation operations (Meyer and Rowan, 1977). Therefore, the concept of rationality develops and changes (Fogarty, 1996). New institutional theory deems that organisations adopt rational rules and routines to ensure that actions of organisations are legitimate not only for reasons of efficiency (Meyer and Rowan, 1977; Meyer and Scott, 1983; Oliver, 1997). Pfeffer and Salancik (1978) believe this adoption is to sustain the trust of external stakeholders in the organisations' operations.

In similar vein, Scott (1998) argues that organisations will ensure that the external constituents are able to see the institutionalised rules and routines. For instance, establishing the internal audit department in a company to gain legitimacy and sustain its image in shareholders' eyes (Adams, 1994). Another example is that the professional certifications gained by the internal auditors legitimate their functions' performance (Al-Twaijry, 2003). Rationally, in harmony with a social expectation is a means to improve a company's ability in obtaining continuing resources, lessening the likelihood that its behaviours are doubted and increasing survival prospects (Albernathy and Chua, 1996; Covaleski *et al*., 1996; DiMaggio and Powell, 1983; Meyer and Rowan, 1977; Scott, 1987; Tolbert and Zucker, 1983).

The arguments above indicate that macro aspects are the focus of new institutional theory, particularly the understanding of external pressures to change. The environment

creates "organisations in their own image" (Carruthers 1995, p.315). In addition, rationalised rules are reflected in the formal organisational structures, which function as myths and give legitimacy as well as stability to resources of an organisation (Meyer and Rowan, 1977). It is the isomorphism that has an impact on the structure, not the technical criteria. The isomorphism process "is a cultural and political one that concerns legitimacy and power much more than efficiency alone" (Carruthers, 1995, p.315).

Meyer and Rowan (1977) contend that the tendency of organisations to become isomorphic with their environment is because of reasons associated with two essential beliefs of new institutional theory. Firstly, organisations are open systems, in which a number of exchanges and technical interdependencies are the efforts to create harmony with their environments. DiMaggio and Powell (1983, p. 73) clarified as follows:

> …each of the institutional isomorphic processes can be expected to proceed in the absence of evidence that it increases internal organi[s]ational efficiency. To the extent that organi[s]ational effectiveness is enhanced. The reason is often that organi[s]ations are rewarded for their similarity to other organi[s]ations in their fields. This similarity can make it easier for organi[s]ations to transact with other organi[s]ations, to attract career-minded staff, to be acknowledged as legitimate and reputable, and to fit into administrative categories that define eligibility for public and private grants and contracts. None of this, however, ensures that conformist organi[s]ations do what they do more efficiently than do their more deviant peers.

Secondly, the institutional environment is socially constructed**,** and this is reflected in organisational structures. This means that organisations are considered as institutions in themselves and products of their institutional environments. Institutionalised rules which function as rational and objective prescriptions of myths (Meyer and Rowan, 1977) are taken in by organisations to adapt to their environment. Meyer and Rowan (1977) further explain that to the degree that rules are believed to be appropriate, sufficient and reasonable, organisations ought to integrate them to maintain legitimacy by protecting themselves from having their behaviour doubted, and also

increasing the commitment of internal participants and external constituents to the organisation's operations.

According to DiMaggio and Powell (1983), there are two types of isomorphism; competitive and institutional (coercive, mimetic and normative). The competitive isomorphism refers to competition among organisations in an organisational field for resources and customers while the institutional isomorphism refers to the quest for political power and legitimacy. The neo-institutional theory suggests that the pressures from players in the institutional environment lead to isomorphism. Organisations in stronger institutional environments such as state-owned enterprises are subject to greater pressures while organisations such as those in manufacturing operate in environments where their resources depend mainly on the market's evaluation of their products and services and as a result the pressures from the institutional environment are weaker. Organisational structure of SOEs arises from the institutional constraints imposed by the state and the professions and the efforts to achieve rationality with uncertainty and constraint lead to homogeneity of structure (institutional isomorphism). Unlike the competitive isomorphism, institutional isomorphism assumes that organisations seek legitimacy by conforming to a socially constructed environment. Since, this study is undertaken on a state-owned enterprise where the political power and legitimacy are robust, this study focuses on institutional isomorphism consisting coercive, mimetic and normative pressures. The institutional isomorphism types will be presented in the following sections.

2.5.6. Legitimacy as an Essential Concept

A number of scholars (Clegg, 2010; Deephouse and Suchman, 2008; DiMaggio and Powell, 1983; Fogarty, 1996; Meyer and Rowan, 1977) agree that legitimacy is an essential concept in the new institutional theory. Organisations tend to achieve a

legitimation from external institutions in which they depend upon, rather than improve an organisational effectiveness to attain their objectives (Meyer and Rowan, 1977). Adopting the prevailing institutions may give legitimacy to organisations, and increase their own survival (Meyer and Rowan, 1977) by gaining social approval and resources (Oliver, 1991).

Scott (1995, p.45) remark that “legitimacy is not a commodity to be possessed or exchanged but a condition reflecting cultural alignment, normative support, or consonance with relevant rules or laws”. Despite the value of Meyer and Rowan’s work (1977) that contributed to the new institutional theory development, it had no clear definition of legitimacy. Thornton and Ocasio (2008, p.100) indicate that “parts of organi[s]ations had to be loosely coupled from their technical core” as part of the notion of legitimacy. The practice of loose coupling occurs when organisations adjust themselves to the expectations of the external environment, and so legitimacy is acquired. Suchman (1995, p.574) defines legitimacy in a more holistic way: “legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions”. Suchman’s definition (1995) contains two prominent attributes: the formal structures of organisations should conform to prevailing values and beliefs; and legitimacy is a socially constructed reality, a view shared by Deephouse and Suchman (2008). This means that the actors create the desired reality by performing collective actions (Scott, 1987; Selznick, 1949, 1996). In this case, the actors direct the activities and programmes of organisations in a way that fulfils social expectations (Fogarty, 1992). Galaskiewicz (1985) and Meyer and Rowan (1977) suggested that charity programmes are examples of organisational programmes which are aimed to increase the organisational legitimacy to the public.

2.5.7. The Mechanism of Institutionalisation

DiMaggio and Powell (1983) identified an institutionalisation mechanism that creates the homogeneity of companies which is called institutionalised isomorphism. DiMaggio and Powell (1983) explained further that institutional behaviours are shaped by three kinds of forces. Firstly, pressure to comply with regulations and rules published by an individual or organisations, which is namely coercive isomorphism. Secondly, the uncertainty pressure creates a need for self-adjustment to the objectives by imitating procedures which are used by other organisations, and recognised as mimetic isomorphism. Thirdly, pressure to self-adjust to the regulations and norms were issued by professional bodies, namely normative isomorphism. These mechanisms are three institutional pillars as a means to respond to environmental pressures, which then shape the organisational behaviour (Scott, 1995). Scott (1995, p.33) remarks that:

> [i]nstitutions consist of cognitive, normative and regulative structures and activities that provide stability and meaning to social behaviour. Institutions are transported by various carries – cultures, structures, and routines – and they operate at multiple levels of jurisdiction.

The role of isomorphism in institutional theory is presented in the following sections.

2.5.7.1. Coercive Isomorphism

Coercive isomorphism occurs when organisations strongly depend for resources and support on the other organisations or parties, which then respond to pressures by performing organisational changes (DiMaggio and Powell, 1983). Power is the key point of coercion (Scott, 1995). Therefore, the more powerful organisations impose a pressure to change on the dependent organisation when an organisation operates in a wider network (Tolbert and Zucker, 1983).

DiMaggio and Powell (1983) divided the pressures into two kinds: formal and informal pressures. Formal pressures may come from legal and standards, such as law,

the government regulations and standard operating procedures and legitimated rules and structures. Informal pressures are derived from outside organisations upon which the institution relies on administratively and culturally expected in the society. In addition, Scott (1991) suggested two categories of pressures: pressure by means of coercive power and authority. Alterations forced by authority take place more rapidly and with less resistance than those enforced by coercive power. Structural changes, which are driven by authority, could generate higher levels of compliance and stability since these changes are less superficial than change by coercive force (Scott, 1991).

An illustration of a coercive mechanism is a public organisation which experiences a pressure to obey other institutions when survival of one department strongly relies on resources and support from other government departments (DiMaggio and Powell, 1983; Mayer and Rowan, 1977). In terms of the practice of internal audit functions, an example of coercive isomorphism is the requirement of all public SOEs to establish an internal audit department and set the Internal Audit Charter as required by the Capital Market Regulatory Body and Financial Institution (Bapepam-LK), which later changed into Indonesia Financial Services Authority (OJK), as an authoritative body, when the public SOEs enter the capital market. This indicates that the internal auditing within the SOEs is a subject to or at least shaped by regulations set by other organisations.

In the context of internal audit functions, Al-Twaijry *et al.* (2003) conducted a study that used new institutional theory to investigate the development of internal audit department in Saudi Arabia. The study found that the new institutional theory provided an explanation of why some companies did not have internal audit department. Moreover, the study indicated that the companies needed coercive pressure to enforce the establishment of internal audit department.

Arena and Azzone (2007) applied new institutional theory to understand the adoption and characteristics of internal audit functions in Italian companies. The results of the study revealed that coercive pressure affected companies' support for the internal audit function. This coercive pressure consists of the regulations that apply to certain types of industries, such as financial companies and listed companies.

Arena *et al.* (2006) used the new institutional theory to investigate the influence of the relevance of institutional pressures in the development of internal audit department in Italy. The findings of the study indicated that regulations shaped the development of internal audit functions, and its effect was stronger when regulations imposed sanctions.

2.5.7.2. Mimetic Isomorphism

Mimetic isomorphism occurs when organisations face a high level of uncertainty and search for a good model by following the actions of successful organisations (DiMaggio and Powell, 1983). In this case, the imitation processes are triggered by the uncertainty condition which deals with organisational technologies, goals and environmental expectations. Therefore, the organisational fashions tend to spread through mimetic isomorphism (Carruthers, 1995). The tendency to mimic operational models of successful companies and willingness to receive techniques of fashionable business could protect the organisations from the uncertainty (Abrahamson, 1996; Granlund and Lukka, 1998). The organisations select the other successful or legitimate organisations as their benchmark in order to reduce the uncertainty or to sustain the survival (Baldridge, 1977; DiMaggio and Powell, 1983; Tolbert and Zucker, 1983). In addition, a company will count on professional specialists, who will influence the corporate strategies, to deal with environmental uncertainties (Thomas, 1989).

As discussed in the prior section, the study of Arena *et al.* (2006) on Italian companies found that companies seek to model themselves on the practices of similar

organisations which they perceive to be more legitimate or successful. Moreover, the study of Arena and Azzone (2007) as discussed earlier, found that mimetic force in Italian companies was explained by company size. Size is a significant driver of firms' choices regarding both the adoption of internal audit department and its structural characteristics.

2.5.7.3. Normative Isomorphism

Normative isomorphism is based on a premise that organisational change is achieved through the process of professionalism. This process occurs through two mechanisms: firstly, formal education and research-based products from authoritative experts, and secondly, professional networks that share science and technology (DiMaggio and Powell, 1983). In 1991, DiMaggio and Powell claimed that the normative pressures could be transferred through education, professional standards, and inter-organisational networks.

The process of normative isomorphism can be seen in the practice of internal audit functions through recruiting the internal auditors who have knowledge and experience in internal auditing as the basic foundation for conducting their duties. Moreover, the internal auditors are facilitated to maintain their professional competence by being provided with continuous professional education and training as well as joining professional networks of internal auditors.

In the context of audit competencies, at the earlier stage the competencies of internal auditor are obtained from the university level, and are then enhanced by gaining a Certified Internal Auditor and other professional qualifications. This creates the potential to increase the number of internal audit staff and the Institute of Internal Auditor (IIA) organisations in that region and enhance the momentum for the diffusion of internal audit functions to similar establishments. The increasing internal auditor

competency within companies will enhance the conformity with IIA Standards (Al-Twaijry *et al.,* 2003). This condition will drive the occurrence of isomorphism and the internal audit functions will be established in line with the objectives of the internal audit profession. This demonstrates that the internal auditors' competencies and knowledge and also how others can similarly benefit (Abbott, 1988). Thus, the status and prominence of the internal audit department will motivate other organisations to adopt International Standards for Professional Practice of Internal Auditing (ISPPIA). Therefore, the IIA would be able to accelerate the process of institutionalisation through the dispersal of internal audit department in all sectors of the economy (Al-Twaijry *et al.,* 2003; DiMaggio and Powell, 1983).

The study of Al-Twaijry *et al.* (2003) found that the establishment of IIA local affiliates in Saudi Arabia was one of the most significant pressures for the establishment of internal audit departments in the country. Arena and Azzone (2007) discovered in their study that normative isomorphism is a key aspect in shaping the characteristics of internal audit departments. Professional bodies have important roles for enhancing the quality of internal auditors. Also, Arena *et al.* (2006) uncovered that professional bodies (for example the IIA) and consultants influenced the development of internal audit departments in Italian organisations.

2.5.8. The Concept of Decoupling

Organisations are driven to incorporate the prevailing rationalised concepts of organisational work and institutionalised norms, beliefs and practices prevalent in the society in which they operate (Meyer and Rowan, 1977). Organisations who operate within their cultural context will obtain more legitimacy (Carruthers, 1995), since they are 'seen' to be able to meet the social expectations (Fogarty, 1992) by ceremonially adopting institutionalised policies, programmes, techniques, products and services

which function as powerful myths (Meyer and Rowan, 1977). According to Fogarty (1996, p. 249):

> Organi[s]ations must signal, through their program[me]s and priorities, that they are doing all that can be done, and that this is being done in the ways that society has reason to believe will work. This implies that control and coordination necessary to achieve goals are not purely technical, but instead reflect the internalisation of shared typifications.

The institutionalised programmes are applied to create the good image in order to impress the society. For example, the society is offered donations, loans and investment programmes by the organisations with the legitimacy in return (Meyer and Rowan, 1977).

Nonetheless, organisations may demonstrate to the external environment that they are operating in keeping with what is expected by the external environment when, in fact, this is not the case (Meyer and Rowan, 1977). The adoption resulted in decoupling or loose coupling experience of organisations (Meyer and Rowan, 1977; Orton and Wick, 1990); a deviation between what given the formal organisational structure, they should do and actual organisational practice (Fogarty, 1992). This means that the organisations tend to do a loose resemblance to their official roles. Consequently, they fail to give attention to efficiency and effectiveness principles (Meyer and Rowan, 1977; Mouritsen, 1994; Zucker, 1987). Meyer and Rowan (1977, p. 357) explained the process of decoupling as follows:

> [a]ctivities are performed beyond the purview of managers. In particular, organi[s]ations actively encourage professionalism, and activities are delegated to professionals. Goals are made ambiguous or vacuous, and categorical ends are substituted for technical ends. Hospitals treat, not cure, patients. Schools produce students, not learning. In fact, data on technical performance are eliminated or rendered invisible. Hospitals try to ignore information on cure rates, public services avoid data about effectiveness, and schools deemphasize measures of achievement. Integration is avoided, program[me] implementation is neglected, and inspection and evaluation are ceremonialized.

Decoupling or loose coupling occurs since the formal organisational structures function only as symbols (Scott, 1987). This means that "formal structure has much

more to do with the presentation of organisational-self than with how things actually transpire within the organisation" (Carruthers, 1995, p. 315).

In terms of internal auditing, Al-Twaijry *et al.* (2003) contends that organisations are sometimes involved in decoupling, that is, actual organisational practice may be different from what the external appearance of an organisation suggests. Furthermore, in the context of one internal audit department, Al-Twaijry *et al.* (2003) found that genuine operations of internal audit departments in Saudi Arabian companies were decoupled from the expectations of how they operate and prescribed International Standards for Professional Practice of Internal Auditing (ISPPIA). Moreover, they concluded that ISPPIA is not affected by departments, and equally, internal audit department have only a limited influence on work performed by ISPPIA. In addition, they believe that the tasks completed by internal audit departments occur without examination by outside agencies, which allows the internal audit department to function according to their own business process. Hence, organisations may have an internal audit department, but it may not necessarily function in line with ISPPIA guidelines. Thus, decoupling may take place when organisations demonstrate to the business world that they are operating in a perceived way internally, when from the point of view of the external environment more generally that they are in fact falling short of those expectations (Meyer and Rowan, 1977).

2.5.9. Organisational Responses to Institutional Pressures

Organisations are not automatically forced to obey institutional pressures. In terms of facing the pressures, the powers and interests within the organisation determine the responses of the actors which could differ from those suggested by the studies of new institutionalism. The responses are conducted in order to gain legitimacy, and they comprise four strategies as suggested by Dowling and Pfeffer (1975) and Lindblom

(1994). Firstly, organisations change their behaviour to conform to the prevailing definitions of legitimacy and inform the changes to the relevant public. Secondly, organisations could use their sound performance to influence external expectations. Thirdly, the organisations can associate themselves to a strong legitimacy base of symbols, values or institutions to manipulate social perception. Fourthly, the organisation changes the existing social legitimacy to fit with the organisational practice.

According to Oliver (1991, p.151), the organisational responses to institutional pressures:

> …will vary from conforming to resistant, from passive to active, from preconscious to controlling, from impotent to influential, and from habitual to opportunistic, depending on the institutional pressure toward conformity that are exerted on organisations.

In other words, the existing institutions will limit an organisation's capability to make a change (Pfeffer, 1981).

Further, Oliver (1991) suggests acquiescence, compromise, avoidance, defiance, and manipulation as five strategic responses to institutional pressures. Acquiescence means compliance to the institutional pressures which consist of three kinds of tactics: comply, imitation and habit. Comply tactics means obeying regulations and rules consciously, whilst Imitation means copying successful institutional models, and Habit means unconsciously following invisible, taken-for-granted norms.

The second response, Compromise is a strategic response which is undertaken when there is a conflict between internal and external institutional pressures in relation to efficiency. The Compromise strategy may be performed in three different ways: balance, pacify and bargain. The Balance tactic is used to balance the expectation of multiple constituents. The Pacify tactic is used to please and accommodate a variety of institutional elements. The Bargain tactic is used to negotiate with the institutional stakeholders (Oliver, 1991).

The third response is Avoidance strategy which is related to "…the organi[s]ational attempt to preclude the necessity of conformity" (Oliver, 1991, p.154). This strategy consists of three means: conceal, buffer and escape tactic. The Conceal tactic is associated with the response to disguise the fact that it does not intend to implement the requirement using rational plan (Oliver, 1991). The Buffering tactic refers to an "…attempt to reduce the extent to which it is externally inspected, scrutinized, or evaluated by partially detaching or decoupling its technical activities from external contacts" (Oliver, 1991, p.155). According to Oliver (1991, p. 155) the Escape tactic means "…an organi[s]ation may exit the domain within which pressure is exerted…or significantly alter its own goals, activities, or domain to avoid its necessity of conformity altogether."

The fourth response is Defiance strategy which is related to "…a more reactive resistance to institutional processes" (Oliver, 1991, p.156). This strategy comprises three forms of tactics: dismiss, challenge and attack. The Dismiss tactic is characterised by "ignoring institutional rules and values" (Oliver, 1991, p.156). The Challenge is described as "…offensive in defiance of these pressures and may indeed make a virtue of their insurrection" (Oliver, 1991, p. 156). The Attack is indicated by "…the intensity and aggressiveness of the organi[s]ation's active departure from institutional pressures and expectations" (Oliver, 1991, p.156).

The fifth response is Manipulation strategy which refers to the way organisations redefine the organisational reality perceived by others. Oliver (1991, p. 157) contends that manipulation is used to "actively change or exert power over the content of the expectations themselves or the sources that seek to express or enforce them." Manipulation strategy covers three tactics: co-opt, influence, and control (Oliver, 1991). Co-opt tactics could be conducted by someone who decides to "…persuade an

institutional constituent to join the organi[s]ation or its board of directors" (Oliver, 1991, p.157) to neutralise institutional opposition and enhance legitimacy. Influence tactics is "…more generally directed toward institutionalized values and beliefs or definitions and criteria of acceptable practices or performance…" (Oliver, 1991, p. 158). Controlling tactics refers to "…specific efforts to establish power and dominance over the external constituents that are applying pressure on the organi[s]ation" (Oliver, 1991, p. 158).

In terms of the organisations' responses, Scapen (1994) suggested that the implementation of a certain response is restricted by the existing institutions. Organisations want to be seen as competent and acceptable, which are the key reasons for them to adapt to the environment. Therefore, organisations are likely to adopt similar practices and structures to conform to socially accepted beliefs (Covaleski *et al.*, 1993; DiMaggio and Powell, 1983).

2.5.10. Institutional Theory: A Critique

Briefly, the institutional theory comprises two different theories: old institutional theory and new institutional theory. The focus of view of these theories is different: micro level of an organisation is the focus of the old institutional theory, whilst the macro level is the emphasis of the new institutional theory. As a result, a number of scholars (Christensen, *et al*. 1997; Kraatz and Zajac, 1996; Selznick, 1996) have criticised the theory, particularly the new institutional theory as an oversimplified view of organisation.

The new institutional theory is also criticised as it concerns the roles of actor, power, and interest (Boons and Strannegard, 2000; Carruthers, 1995; Perro, 1985; Scott, 1995). In this case, the scholars argue that the theory ignores the actors and their capabilities to influence and shape organisations, which means the theory disregards the power and politics in the institutionalisation process.

However, it can be argued that the role of power in the process of institutionalisation is considered by the institutional theory. Bourdieu (1990) claims that the practice of behaviour in the immediate environment of individuals affects them. Accordingly, there exists a formal structure and practice of actors' influence on individuals' behaviour as well as organisational realities. Similarly, Shepsle (1989) contends a sufficient number of individuals could disrupt institutions and resulted in the institutional change. The process of an institutional change can be dominated by the powerful individuals who are not satisfied with the present situation. The main determinant of change is the power position of individuals, not the number of individuals.

On the other hand, institutions also shape power and preferences of actors (Hall, 1986; Levi, 1990). The theory that institutions contain and create power (Levi, 1990). Hall (1986, p. 19) postulates that:

> The organi[s]ation of policy-making affects the degree of power that any one set of actors has over policy outcomes...Organi[s]ational position also influences an actor's definition of their own interests, by establishing institutional responsibilities and relationships to other actors.

The power of organisational actors' translations and use of social expectation is reflected through the institutionalisation of organisational rules and routines (Clegg, 1979). This argument means that the power and conflicts of interest within an organisation motivate the response of powerful actors to external pressures. The pressures will be interpreted by powerful actors or leaders, and then used as power sources to decide their organisational responses (Finstad, 1998; Jeppersen 1991). Therefore, the statement that institutional theory overlooks power issues cannot be accepted.

Nonetheless, the main deficiency of institutional theory is that the theory does not acknowledge a specific concept of power in the institutionalisation process discussion, and not on ignores the power.

2.5.11. Research Framework

Internal audit functions are the kind of actions or activities that are socially constructed by individuals, both within and outside organisations as an institutional practice (Flint, 1988). In order to understand the practice of internal audit functions this study uses the new institutional theory as a lens to investigate the practice. New institutional theory has a basic tenet that structures and behaviours of an organisation are affected by the features of its environment (DiMaggio and Powell, 1983).

According to Schotter (1981), social institutions exhibit regularity in social behaviour which is approved by all of society’s members, determine behaviour in specific recurrent situations, and are either self-regulated or regulated by external authorities. The social construction feature of internal audit activities can be seen from its functions which have evolved over time. It started as a part of the accounting department, acting as independent appraisers of accounting, had operational independence, and lastly evolved into providing added value to an organisation. This scope of work developed as a response to the demands of society which can be traced to the developing of internal audit standards.

As socially constructed activities, organisational actors can construct the practice of internal audit functions so as to achieve legitimacy and show that the internal audit unit operates in line with socially acceptable beliefs, values, rules and norms. The issuing of the Internal Audit Charter is a signal from the director of an internal audit unit to stakeholders that the internal auditors will behave responsibly and in a manner consistent with the charter. The existence of the charter is important as it is a legal basis

for internal auditors in conducting their duties (Adam, 1994; Burnaby, 1994; Courtemanche, 1986, and Hughes, 2004). The acquired legitimacy is essential for a company since it needs to demonstrate social worthiness to mobilise resources (Oliver, 1991).

DiMaggio and Powell (1983) stated that pressure to obey other institutions occurs when the survival of one department strongly relies on resources and support from other government departments. Government mandates, state-sponsored legitimacy and more subtle and less explicit political mechanisms, could be deemed to be indicative of coercive isomorphism (DiMaggio and Powell, 1983). In the case of Indonesia particularly for SOEs, the existence of coercive isomorphism may be indicated by the pressure to comply with government laws and regulations in order to obtain legitimacy since the SOEs are financed by the Indonesian government. In terms of the practice of internal audit functions, SOEs are required by a number of regulations, such as the Decree of Ministry of SOE to have an internal audit department to perform internal audit activities, for public SOEs these activities also are regulated by the Capital Market Regulations. These regulations provide a detailed prescription for performing the functions of internal audits which cover auditing, and consulting functions, as well as essential features of the functions. Thus, these regulations may give signals to the existence of coercive isomorphism on the practice of internal audit functions by SOEs.

Normative isomorphism is based on a premise that organisational change is achieved through the process of professionalism. This process occurs through formal education and research-based products from authoritative experts, professional networks that share science and technology (DiMaggio and Powell, 1983), as well as professional standards (DiMaggio and Powell, 1991). Abbott (1988) states that the internal audit professional body, the IIA, would be expected to legitimise internal audit functions by

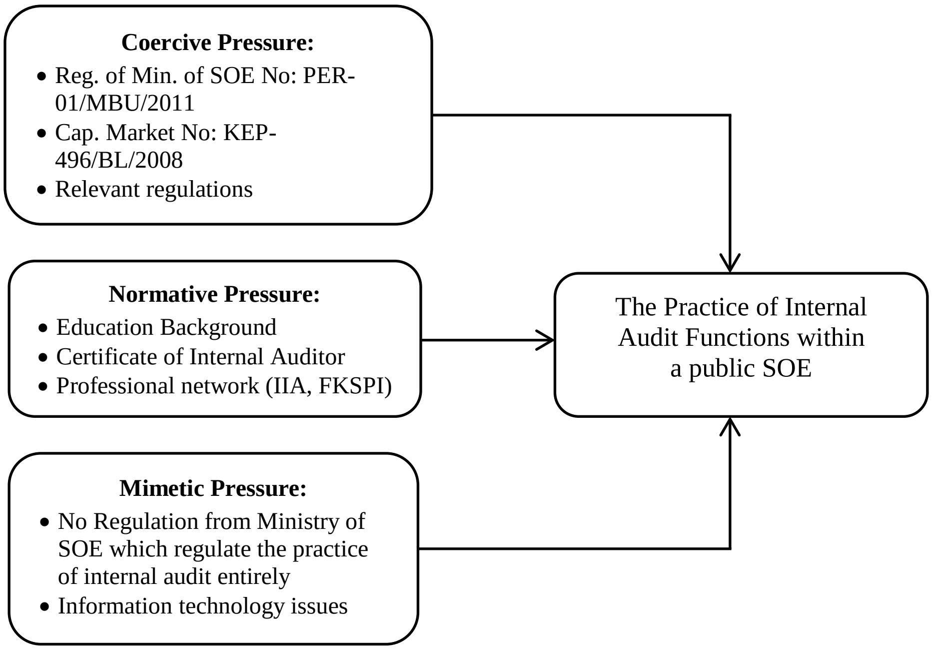
demonstrating both the IIA's competence standards and the expertise of the internal auditor, and how this expertise can be used to the benefit of others.

In Indonesia, university students that major in accountancy must complete various accounting subjects including auditing as one of the core subjects. The auditing subject will give basic knowledge to become either internal or external auditor. At the early stage the competencies of internal auditors are obtained from the university, and then enhanced by becoming a Certified Internal Auditor (CIA) through the examination held by professional organisation. The test is provided through two organisations: IIA-Indonesia affiliated to IIA-international and the Internal Auditor Association. There is a belief in society that internal auditors have to possess appropriate knowledge of the profession gained from university and/or from professional organisations. This belief may create pressure on the way an SOE recruits its internal auditors. This practice may be seen as the signal of the existence of normative isomorphism.

DiMaggio and Powell (1983) contend that mimetic isomorphism is a process of change started internally by the organisation. Mimetic isomorphism occurs when organisations perceive that internal audit functions impact on improvement in organisational control and operational performance which is important to it being adopted. In Indonesia, particularly for SOEs, the mimetic could occur when internal auditors within an unsuccessful SOE may duplicate the practice of internal audit functions of a successful SOE. Another possibility is that internal auditors in an SOE may mimic the practice of internal audits of a leading company in the same industry. This might happen since there is no reliable regulation from the Ministry of SOE that regulates a complete internal audit practice for SOEs. The uncertainty condition in terms of the best practice of internal audits will generate mimetic isomorphism.

Based on the discussion of the relevant theory of this research, Figure 1 shows the research framework of this study.

Figure 1
Research Framework of the Study



2.6. Summary:

This chapter presents two main sections, the literature review and the research framework. The literature review comprises three main ideas which encompass the evolution of the functions of internal audit, the concept of internal auditing and its fundamental qualities, and also the practice of internal auditing. The empirical studies show that the regulations and the Standards of Internal Auditing had an impact on the internal audit practice. Moreover, the literature and empirical research findings prove that the practice of internal auditing is socially constructed by the institutional environments, such as government regulation, professional bodies and an uncertain business condition. Therefore, studies of internal auditing should be framed by an appropriate theory, namely the institutional theory. The basic tenet of institutional theory is that an organisation's actions are socially constructed by the institutional

environment surrounding them. Yet, only a few empirical studies use the institutional theory as a theoretical framework to understand internal auditing. Also, the studies have not yet addressed to what extent the internal audit unit bows to institutional pressures in the internal audit charter and the implementation of the charter in practice. Therefore, this study attempts to contribute to the internal auditing literature by filling this gap.

Chapter 3
Methodology

3.1. Introduction

This chapter describes the research methodology used to investigate the practice of internal audit functions in an Indonesian public State-Owned Enterprise (SOE) from the perspectives of Institutional Theory. Initially, the epistemological stance of employing interpretive study is discussed. It is followed by the justification of employing a qualitative methodology and a single case study. The techniques of data collection and analysis are described in connection with the broad nature of this study. Finally issues around trustworthiness and ethical considerations are addressed.

3.2. Research Paradigms

This section discusses the ontological and epistemological approaches and how they affect the research methodology of this study. Having an understanding about the basis of philosophical concepts is vital in order to conduct solid research in that these concepts allow the researcher to understand the nature of how knowledge can be acquired. Henn *et al.* (2006) suggest two critical aspects of research: what can be considered as knowledge? And, how can that knowledge can be acquired? This implies that how a researcher views reality in order to gain valid and reliable knowledge from it is determined by the research paradigm used by the researcher. Bryman (1988) and Myers (2009) stress the importance of following a research paradigm as a guide. A research paradigm is a world view that covers a number of perspectives: ontological, epistemological and a methodological perspective (Guba and Lincoln, 1998). Ontology is the theory of the nature of reality, while epistemology is a theory of gaining knowledge about reality (Myers, 2009). Research methodologies are strategies of

inquiry that provide specific direction for procedures in a research design (Creswell, 2009).

Ontology deals with the nature of reality (Collis & Hussey, 2003; Creswell, 1998; Denzin & Lincoln, 1998). It deals with two questions: whether reality is socially constructed that is, a product of people's consciousness and should be treated subjectively, or whether reality is independent and thus should be treated objectively (Cresswell, 1998; Eriksson and Kovalianen, 2008). Ontologically, this study assumes that the internal audit functions is socially constructed by the actors since such practice is perceived as a reality or social product that results from human interaction, creativity, and symbolic interaction created by actors (Berger and Luckmann, 1967; Burrell and Morgan, 1979; Flint, 1988; Humphrey and Moizer, 1990; Morgan, 1980).

Epistemology is concerned with the process of how knowledge is derived (Bisman, 2010; Collis and Hussey, 2003; Denzin and Lincoln, 1998). Since a social constructionist approach is an ontological assumption used in this study, then qualitative research is an appropriate epistemological method. According to Guba and Lincoln (1988 in Creswell, 1998), in order to capture a clearer picture, qualitative research demands researchers lessen their distance from the object being studied. Based on the ontological and epistemological standpoint mentioned above, this study adopted an interpretive paradigm when interpreting phenomena. Using such a paradigm allows the researcher to draw deeper insights from the studied issue and provide reasons for the observed phenomena.

Moreover, the knowledge gained enables the researcher to increase understanding about a phenomenon within a particular situation, without letting the researcher's preconceptions influence the outcomes (Orlikowski and Baroudi, 1991). Orlikowski and Baroudi (1991) explained further that the phenomenon is directly studied in its natural

context from the perspective of participants. Similarly, Eriksson and Kovalainen (2008) claim that from an epistemological standpoint of interpretivism, knowledge is available through social actors. In this case, this study obtained an understanding of the practice of internal audit functions within the institutional environment in an Indonesian public SOE context from the perspective of the internal auditors as the actors of such practice.

Methodology plays a vital role in linking theory and method, since it reflects specific views of ontological and epistemological theory and assists the researcher to choose an appropriate research method (Bryman, 1988). The study adopts an empirical approach focusing on human interpretations (particularly the internal auditors) of institutional pressures which comprise government regulations, professional bodies, and the uncertain business environment. According to Elbardan *et al.* (2016); Walsham (1995a); and Yin (2009), an in-depth case study is often used for such interpretative investigation.

3.3. The Choice of Interpretive Paradigm

This section discusses the rationale of choosing the interpretive paradigm as the philosophical foundation of this study. Collis and Hussey (2009) suggest that there are two major factors influencing an adoption of a research paradigm: firstly, the dominant paradigm in the research domain and secondly, the nature of the research problem. The research aims to investigate the practice of internal audit functions in an Indonesian public SOE from the perspective of institutional theory. In order to achieve this aim, the research investigates the responses of the internal audit unit toward the institutional pressures which led the practice of internal audit.

This study adopts an interpretative paradigm as it allows the researcher to draw knowledge from analysing the issue and making conclusions from its real context, based on the subjective and shared meaning from the research participants. Further,

interpretative study is concerned with how individuals in a social group view social events and settings. Interpretive study aims to explore and explain the interrelation and interdependence of various factors in a particular social setting, it does not seek to prove a hypothesis (Oates, 2006). Therefore, the nature of interpretative study enables the researcher to understand the practice of internal audit functions from the participants' perspective in the context of an Indonesian public State-Owned Enterprise (SOE). This indicates that the participants' personal views are elicited to build insights about the practice of internal audit function. Erikson and Kovalainen (2008) stress that the way to access changing and individual constructed reality can only be obtained from social construction, for instance language. Ultimately, the researcher can understand the complexity of human sense making from different individuals, and then construct insights about the social context of the practice of internal audit functions in an Indonesian SOE context.

Likewise, Erikson and Kovalainen (2008) suggest the way to gain knowledge is from social actors' points of view or from individuals taking part in a particular social setting. This view is associated with the epistemological view that the external world cannot be accessed by relying only on our own interpretation of a social issue.

The existing literature on the practice of internal auditing shows that a positivist paradigm has been applied to carry out investigations. One of the pitfalls of this paradigm is that it simplifies the world or phenomenon and places it within the "box" of cause-effect relationships.

According to Flint (1988), and Humphrey and Moizer (1990), internal auditing is socially constructed; therefore, people involved in it are social actors. By employing an interpretative approach researcher can investigate in depth what the responses of social actors to the institutional pressures in an Indonesian public SOE context, which lead to

the practice of internal audit. An interpretive paradigm also enables the researcher to examine the interaction between the practice of internal audit functions and its institutional environment, consisting of government regulations, professional bodies and an uncertain business environment. Further, the nature of this study is to understand the interaction between actors' practices and their environment. As such, employing the interpretative stance is seen relevant for this purpose. As noted previously, this study does not seek to prove a hypothesis or to make quantifications or to identify significance or causality. Rather, this study aims to capture and explain the interrelationship and interdependence between actors and action. Pettigrew *et al.* (2001, p.699) suggest that "change explanations are no longer pared down to the relationships between independent and dependent variables but instead are viewed as an interaction between context and action".

3.4. Qualitative Research Methodology

Collis and Hussey (2009) define methodology as the overall approach of the research design that indicates clearly the selected paradigm underpinning the assumptions. The research design used in this study is qualitative investigation.

The major reason for choosing the qualitative research methodology is due to the limitations of quantitative methodology. Taylor and Bogdan (1988) argue that quantitative methodology cannot provide in-depth information about the research context and the subjective meaning of actors' actions. Another criticism is that it only provides snapshots of a problem and ignores the issues or variables which are not included in the research design (Avital, 2000). Despite its strength in presenting the correlation among variables, quantitative methodology does not give many insights about why actions happen in certain ways or causal relationships. For these reasons, the use of a qualitative design is expected to fill these gaps.

Qualitative methodology is perceived to have abilities to help a researcher to gain a deep understanding from a social context in order to draw insights about the studied phenomenon (Silverman, 2010). When little information is known about an issue, this methodology is appropriate. The nature of such methodology allows the researcher to explore all related aspects of a studied issue and to examine their relationships. It attempts to provide explanations from multiple points of view in order to develop a holistic understanding about a studied phenomenon (Creswell, 2009). This methodology has also gained recognition among many researchers (Berg, 2009; Patton, 2002) and has been used to investigate uncovered meanings indicated by social actors. To do this, the qualitative researchers frequently talk to the participants directly face to face and observe their behaviours within the social context (Creswell, 2009). However, qualitative researchers are often less rigorous and provide less opportunity to generalise their research findings (Yin, 2009). Despite such drawbacks, qualitative methodology can be used to explore a social phenomenon which is not aimed to build a general law.

3.4.1 Justifications for using Qualitative Research

The main reason for adoption of qualitative research is the need to obtain an understanding about the practice of internal audit in an Indonesian public SOE context. This is important in order to maximise the ability to understand the diverse perspectives from members of such a dynamic and complex social phenomenon and to obtain rich data. The following paragraphs discuss the theoretical and philosophical considerations of adopting qualitative research.

To start with, qualitative research methodology allows the researcher to consistently align theoretical and philosophical perspectives. Further, qualitative research is considered an appropriate methodology to investigate research problems that are context driven, interpretive in nature and aim to understand how things work. Klein

and Myers (1999) suggest that the philosophical background to conduct this type of interpretive study is intended to gain insights on social reality. Accordingly, the choice of qualitative research methodology is consistent with the nature of the current study, namely the interpretation the social phenomenon under investigation. In addition, employing this empirical study, the researcher considers that social interaction leads to the occurrence of social features and reality (Johnson and Onwuegbuzie, 2004). This is certainly the case in the adaptation of internal audit functions which have developed through the interaction between individuals and the institutional environment of Indonesian public SOEs.

Second, this study investigates the complexity and process in a less studied phenomenon in order to understand the dynamics of process of how institutional environment shapes the internal audit functions. For this reason, a qualitative research approach was chosen. Ball (1989) in Seal (1993) argues that the practice of internal audit functions is inseparable from the institutional context within which it is embedded.

As explained in chapter 2, empirical qualitative research on internal auditing has been rarely conducted, and studies concerning the practice of internal audit functions within the institutional environment of Indonesian SOE context were hard to find. Therefore conducting a study by employing a qualitative inquiry is considered the most appropriate option to gain understanding in order to fill the gap in internal auditing research. Further, the flexibility of this approach will allow the researcher to understand the nature of the dynamics of the phenomena under investigation, which cannot be achieved through a quantitative approach.

Third, the use of a qualitative approach enables the researchers to gain contextual data (Bryman, 1988). With this methodology, the researchers are able to conduct a study in a natural setting in order to understand the phenomena (Silverman, 2010). As

this study is also confidential and subjective, the researchers need rich contextual data in order to be able to create a meaningful understanding of the issues investigated. Denzin and Lincoln (1998), and Miles and Huberman (1994) highlight that collection of qualitative data in natural settings should consider the effects and richness of the environment, which consists of social and cultural contexts. These contexts within which the participants work and interact can only be understood by employing a qualitative approach. Accordingly, the use of a qualitative study to achieve the aim of this study is suggested.

3.5. Case Study Research Strategy

This study employs qualitative approach in which interpretivism is used as the epistemological stance. This section focuses on the selection of a research strategy. Strategy is different from tactics (Remeniy *et al.*, 2002). The adoption of an overall approach is called strategy, while the specific details of data collection and analysis are regarded as tactics. Henn *et al.* (2006) describe research strategy as *how* to study a given issue, whilst the available technique variation that can be employed to collect and analyse data is called research methods (Eriksson and Kovalainen, 2008).

There are a number of qualitative research strategies that can be employed to investigate the practice of internal audit functions. However, Creswell (2009) argues that the strategy choice is greatly dependent on the research aims and objectives. Hence, the researcher considers the case study as the most appropriate strategy for investigating the issue of this study in depth. Yin (2009, p. 18) defines case study as "an empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident". Myers (2009) maintains that in–depth case studies are the most appropriate research strategy for conducting empirical research when following the interpretive

paradigm. The case study is also claimed as a research strategy of an encompassing method which involves the logic of design, data collection techniques, and specific approaches to data analysis (Yin, 2003). In other words, the case study is a comprehensive research strategy, not merely a data collection tactic or a design feature alone (Stoecker, 1991 cited in Yin 2003).

A number of scholars (Benbasat *et al.*, 1987; Cavaye, 1996) have identified the main characteristics of a case study method which include that: there is no variables control; it studies a phenomenon in its natural context; the site at which the phenomenon studied can be one or a few; it uses multiple means to collect data; it employs qualitative techniques to collect and analyse data; and it focuses on contemporary events. Yin (2003, p. 21) also proposes five components involved in the research design of a case study, which consist of:

(a) a study’s questions,
(b) its propositions, if any,
(c) its unit(s) of analysis,
(d) the logic linking the data to the propositions, and
(e) the criteria for interpreting the findings

3.5.1. Justification of the Case Study Use

There are a number of considerations for choosing a case study as the research design in order to understand the nature of the research setting along with its contextual features. First, the research strategy should be based on the nature of the research problems and objectives. Hessler (1992) believes that research problems and objectives have become the fundamental basis of choosing an appropriate research strategy. This implies that the selected strategy should enable the researcher to answer the research questions of their study (Eriksson and Kovalainen, 2008). It also means that the chosen strategy should allow the attainment of the research objectives. Based on the objectives of this study, that is to find how the institutional pressures shapes the practice of internal

audit functions in an Indonesian public SOE, a case study is found to be the most relevant research strategy. Yin (2003) claims that 'how' or 'why' questions are the most appropriate types of questions in case study research, and a prerequisite to adopting a case study as the research strategy. With this particular strategy, the researcher can investigate the given issue in an appropriate manner which in turn can lead the researcher to achieve the research objectives.

Second, a case study provides a range of benefits for the researcher. For instance, a case study provides the opportunity for the researcher to gain diversity, complexity and to avoid simplistic research designs (Erikson and Kovalainen, 2008). The case study also focuses on understanding the dynamics present within single settings (Eisenhardt, 1989). This enables the researcher to gain a comprehensive meaningful picture of phenomena found in real-life events, for instance organisational and managerial processes, daily-life activities, and a community social system (Yin, 2003). Moreover, Yin (2003) states that the case study method is best used when researchers want to cover contextual conditions as they believe these conditions might be highly pertinent to their phenomenon of study. Further, Erikson and Kovalainen (2008) suggest that a case study is methodologically associated with an interpretive approach. The interpretive paradigm supports a less structured case study and emphasises the explanations of case study participants (Doolin, 1996).

Third, the status of the research and the theory about the research problems determine the use of a particular research strategy. As indicated in the literature review, the study of internal auditing practice is still limited particularly with respect to institutional theories. Hessler (1992) suggests that if the research problem is in its infancy then the case study strategy is relevant. In other words, case studies are appropriate when fewer studies on one particular issue have been conducted. Yin (2009)

also claims the main criteria to determine whether the case study is the proper strategy is by considering the type of research questions. He further argues that if the research questions are about 'how' or 'why', then it is preferable to use a case study.

Neuman (2006, p.58) argues that the case study does not search for the relationship between two or more concepts as the feature of qualitative research relies on interpretive or critical social science. In line with this view, this study does not seek to examine hypotheses, rather it is directed to understanding the practice of internal audit as applied by an Indonesian SOE. Hence, a case study is found to be the most appropriate research strategy. Furthermore, the selection of the case study strategy as the research design is based on the following considerations.

Fourth, Collis and Hussey (2009) claim that a case study is appropriate when research is conducted in the workplace and the researcher does not attempt to control any aspects of the phenomena. This study does not aim apply a treatment to the research variables, but aims to gain understanding of how the institutional environment shapes the practice of internal audit functions in a particular context, in an Indonesian SOE. With the insight gained from the study, the researcher can construct concepts concerning the investigated issue. Similarly, Eisenhardt and Graebner (2007) maintain that case studies will enable the researcher to obtain rich qualitative data offering more insights of complex social process that cannot be revealed by easily with quantitative data. Stake (1995) also claims that case studies are appropriate to investigate complex issues and to elicit intensive data within the research context. Further, the aim of analysis in this study is to understand how and why internal auditors in an Indonesian SOE respond to their context of government regulations, professional bodies and the uncertain business environment.

Fifth, it is appropriate to use case studies when there are limited insights about the issue being investigated. Some scholars (Benbasat *et al*., 1987; Yin, 2009) claim that the case study is the most recommended way of capturing the critical experiences of actors in a social context when there are unclear boundaries between the phenomenon under investigation and context. Similarly, Cavaye (1996) suggests that a case study strategy seeks in-depth understanding of the phenomenon's context, investigates a predefined phenomenon and contributes to knowledge by relating findings to generalisable theory. Case studies also focus on investigating contextual factors and characteristics (Yin, 2009). This makes it an appropriate method to gain insights from practitioners in the internal audit field. In other words, a case study makes it possible to dig deep and gain understanding about one or a few issues of internal audit practice relating to the institutional environment when there is limited knowledge available due to less research in the area.

Further, some scholars also have recommended the use of case studies to investigate the practice of internal audit functions. For instance Al-Twaijry *et al*., (2003), Arena and Azzone (2009), and Humphrey and Moizer (1990) highlight the need to conduct more case studies in auditing. This is indicated by the lack of published scientific reading regarding such practice. In addition, where the institutional environment is one of the influencing factors, most of the available written work on the area is published by practitioners, not researchers. To put it simply, case study is well-suited to obtain insights from practitioners and apply theory, in this research the institutional theory, to understand the contextual phenomena.

This study takes the form of interpretive case study research as it promises a rich description of contexts. In this case, understanding the responses of internal audit unit is a contemporary phenomenon should be studied within its real-life context, the

institutional environment in Indonesian public SOE context that shapes current internal audit practice. For this purpose, this study adopts descriptive case study research based on the aim of study.

Benbasat *et al*., (1987) propose a number of questions to justify the use of case study in investigating a phenomenon. First, can the phenomenon of interest be studied outside its natural setting? The previous discussion indicates that the practice of internal audit functions within the institutional environment in an Indonesian SOE cannot be investigated from outside the context, so the researcher has study within it. Second, must the study focus on contemporary events? As explained above this study focuses on the current responses of the internal audit functions to institutional pressures in an Indonesian SOE context. Is control or manipulation of subjects or events necessary? Controlling and applying treatment to the research variables is not necessary, as case study does not seek to investigate the impact of a treatment. Rather, this study seeks to obtain a holistic picture of knowledge concerning the practitioners' experience and their natural responses to how external factors affect the practice of internal audit functions, that is, government regulations, professional organisations and the uncertain business environment. Does the phenomenon of interest benefit from an established theoretical base? The literature suggests that there is a few studies on this issue so it is necessary to do a more in-depth study in order to build a comprehensive theoretical base. For these reasons, the researcher considers that a case study is appropriate as the research strategy for this study.

3.5.2. Overcoming Case Study Limitation

Despite its benefits, case study has received a number of criticisms. Cook and Campbell (1979) indicate that there have been a number of poor case studies, leaving them open to criticism, especially from the quantitative field of research. For instance,

case study has an issue with internal validity since there is no control to the research variables. However, the internal validity focuses only on explaining the causal relationship for explanatory case studies which is inapplicable to descriptive or exploratory case studies as these types of study are not concerned with making causal claims (Yin, 2003). Other criticism relates to the findings, firstly that they require interpretation, which may be subjective, and secondly that case study findings may not be generalised. In addition, Humphrey (2001, p. 97) asserts that “there is no such thing as a truly ‘correct’ and ‘balanced’ case study - that two researchers are likely to produce two different case studies from visits to the same organisation”.

Yin (2009) identifies that the risk of bias in case study has been a common criticism. In this sense the risk of bias refers to the biased views that can affect the direction of the findings and conclusions. To avoid potential bias researchers can employ triangulation (multiple sources of evidences), which is a common feature of case studies. Neale *et al.* (2006) also suggest another limitation of case study: that is that it can be lengthy. It is lengthy because it contains detailed information in narrative form which might reduce readers’ interest. Therefore, it is important to provide rich information in a digestible manner when writing a case study report. Another major restriction of case study is that the data collected are only related to the case being investigated. Although there are possibilities to set up relationships among the variables, they cannot show direction of causality (Cavaye, 1996). In addition, despite having limitations in terms of external validity, Yin (2014) claims that case study results can be generalised for theory but not for the population.

Yin (2003) states that the goal of reliability is to reduce errors and bias in a study. Reliable study allows the next researcher who employs the same procedures to arrive at the same finding and conclusions. These procedures are documented in a research

protocol which can be used as specific tactics to overcome reliability issues in case study. As Yin (2003) points out the protocol is the key to increasing the reliability of case study research and is used to guide investigators in collecting data from a single-case study.

3.5.3. Single-Case Study Design

Case study is a flexible research strategy which is able to investigate single or multiple cases, depending on the principal philosophical assumptions of the researcher (Myers and Avison, 2002). However, Perry (1998) argues that there is no proper rule to determine the total number of cases to be conducted. Similarly, Patton (1990) argues that there are no rules for deciding sample size in qualitative research. Nevertheless, Irani *et* al. (1999) assert that determining the number of cases requires the researcher's discretion and also considerations both of the research aim and questions. Likewise, Eisenhardt (1991) claims that research questions and data to be gathered are the factors in determining the appropriate number of cases.

Yin (2009) claims that a single case study is used when the case has unique circumstances and is also the first examination of the phenomenon. Furthermore, a single case can be utilised to test or confirm a theory if it meets the condition required by the theory. This allows single case findings to contribute significantly to theory extension or development and to direct the focus of future study (Yin, 2003). This study focuses on the practice of internal audit functions within the institutional environment in an Indonesian public SOE, which is a unique context as it is different with other institutional environments in other developing and developed countries. The unique context of Indonesia may be contributed from the colonial period in Indonesia that created massive regulations on the internal auditing. Moreover, there is no research concerning such practice in Indonesian SOEs. Furthermore, this study used institutional

theory that holds the view that the institutional environment is socially constructed, as are also the internal audit functions. Therefore, based on these research characteristics, a single case study is appropriate.

The level at which research is carried out and which objects are researched is called the unit of analysis (Blumberg *et* al., 2011). The unit of analysis should be associated with "the major entity that you are analysing in your study" (Trochim, 2006). It could be an individual, a group of individuals (such as a family or professional association), a social category (for example a social class or gender) or an organisation or individuals within an organisation (Neuman, 2006; Yin, 2003). The unit of analysis in this study is an internal audit unit to understand how the institutional pressures shape the practice of internal audit. In terms of analysis purpose, the study investigates the response of the internal audit unit toward the institutional pressures. The response is demonstrated in the internal audit charter and implementation of the charter in practice. Afterwards, the case study findings will be further examined using the institutional theory framework, particularly using the strategic responses to institutional process developed by Oliver (1991). The findings also will be examined using method suggested by Fogarty (1996) by comparing the charter and its implementation.

Benbasat *et al.* (1987) suggest that industry, geographic coverage and specific technologies are the organisations' characteristics which could be used for site selection basis when investigating an organisation-level phenomenon. The case under study is conducted in a public SOE in Indonesia since the Supreme Financial Audit of Indonesian Government (BPK), and the Financial and Development Supervisory Agency (BPKP), a government internal audit department, each reported over 6000 and 700 suspected corruption cases respectively during the years 2001 – 2004 in government institutions, including SOEs (Oxford, 2004). In addition, several CEOs of

the SOEs were convicted on corruption scandals by the Corruption Eradication Commission (KPK) (Umar, 2011). Another reason is that the SOE has a crucial role in the national economy, as an income source for the government, and SOEs' poor financial performance resulted in the government having financial difficulty. Moreover, there is no study on the practice of internal audit functions within an institutional theory framework in the Indonesian SOE context. In addition, the internal audit functions are always a subject of government regulations, and subject to the demands of local and international professional bodies. Thus, all these reasons contributed to choosing SOEs for a case study.

However, the participation of public SOE in this study is on voluntary basis. In this case, the researcher used personal contacts to gain the access to the SOE as well as encourage their cooperation by sending invitation letters through e-mail to the CEOs of the several SOEs. These letters explained the research objectives, the importance of the research, and then requested participation. The invitation letter is written in Indonesian language by the researcher, which then checked by one of supervisor who has Indonesian background. The invitation letter then was translated back to English by a certified translator then was also checked by the supervisor who has Indonesian background. Having a single point of contact of the senior officer within selected organisations gave benefits to the researcher which included access and recommendation of the best interviewees to provide the required data (Voss *et al.*, 2002) as well as avoiding duplications of communication (Lewis, 2003).

Most of SOEs refused to participate in this study since the research's topic is related with internal audit units, a confidential field for them. Also they were not confident since they thought that the company's internal audit units and financial performance were not good quality.

3.6. Data Collection

This sub section discusses the process of how the data is collected. Yin (2009) points out that empirical research design is a cohesive and logical process comprising of a number of stages. The first stage is the formulation of ideas and developing the "what" question about the research. The second stage is data collection or "how" the study should be carried out. The third stage is the analysis of the collected data and interpreting "why" questions concerning the research case.

Neale *et al.* (2006) identify a number of potential sources of information of case study which include project documents (e.g. meeting minutes), project reports, including quarterly reports, midterm reviews, monitoring visits, mystery client reports, facility assessment reports, interviews, questionnaire/survey results, evaluation reports, and observation. In collecting data, there are some overriding principles that researchers have to consider. These include a) using multiple sources of evidence, b) creating a case study data base, c) maintaining the linkage between questions, evidence and conclusions. Incorporating these principles will enable the researchers to increase the case study quality (Yin, 2003). Therefore, it is important that researchers follow these principles when collecting evidence from all the sources above. Similarly, the use of multiple sources for collecting data has been highly recommended by a number of researchers in order to increase both reliability and validity of qualitative research (Miles and Huberman, 1994). Therefore, to maintain data validity, this study used triangulation for data collection using interviews, documentation and direct observation. The use of multiple sources also aims to triangulate the evidence acquired.

Triangulation is very important in conducting a case study, as Yin (2009, p.199) suggests that "any case study finding or conclusion is likely to be more convincing and accurate if it is based on several different sources of information". This has strengthened

case study as a research strategy. Yin further (2003) argues that the use of multiple sources of evidence in case studies enables the researcher to gain a wider perspective of historical, attitudinal, and behavioural issues. This has made case study findings and conclusions much more convincing and accurate (Yin, 2003).

Yin (2009) identifies a number of triangulation methods and one of them is employing multiple data collection techniques within a study to check the derived data validity; which makes data triangulation possible (Eisenhardt, 1989). Data triangulation is another type of triangulation which is useful to verify facts through multiple data sources (Flick, 2008). It also enriches the quality of data and finding robustness (Myers, 2009), as well as increases the reliability and validity of qualitative research (Miles and Huberman, 1994). Further, it enables data cross-validation gained from varied sources. In other words, data triangulation allows the researcher to address the potential problem of construct validity since multiple source of evidence enables the multiple measurement of the same context. This has made case study highly rated in terms of its overall quality compared to relying on single source of evidence.

Table 3.1. Six Sources of Evidence: Strengths and Weaknesses

Sources of Evidence	Strengths	Weaknesses
Documentation*	• Stable – can be reviewed repeatedly • Unobtrusive – not created as a result of the case study • Exact – contains exact names, references, and details of an event • Broad coverage – long span of time, many events, and many settings	• Retrievability – can be low • Biased selectivity, if collection is incomplete • Reporting bias – reflects (unknown) bias of author • Access – may be deliberately blocked
	The actions taken at the site: Collecting internal data from the company website, such as annual reports of the company; gathering company information from external sources, such as online newspapers; and compiling a list of relevant law, government regulations and regulations from online sources, such as regulations issued by the Ministry of State-Owned Enterprise.	

Archival Records *	• (Same as above for documentation) • Precise and quantitative	• (Same as above for documentation) • Accessibility due to privacy reasons
	The actions taken at the site: Collecting internal data from a company's archives, such as organisational structure of the company, the company's policy, procedures of internal auditing, a number of evaluation reports on the company, book of the Internal Auditing Standards issued by the IIA as well as Consortium of Internal Auditors of Indonesia.	
Interviews*	• Targeted – focuses directly on case study topic • Insightful – provides perceived causal inferences	• Bias due to poorly constructed questions • Response bias • Inaccuracies due to poor recall • Reflexivity – interviewee gives what interviewer wants to hear
	The actions taken at the site: Performing interviews with all levels of internal auditors in the internal audit department. The interviewees consist of 18 auditors from various positions; one manager-level auditor, five senior-level auditors, 11 middle-level auditors and one junior-level auditor. The total numbers of participants were 18 out of 22 auditors in the internal audit unit being investigated. Four auditors refused to be participated in this study.	
Direct Observations*	• Reality – covers events in real time • Contextual – covers context of event	• Time-consuming • Selectivity – unless broad coverage • Reflexivity – event may proceed differently because it is being observed • Cost – hours needed by human observers
	The actions taken at the site: Observing the office condition in the internal audit department, the meetings held among the internal auditors in small group for each bureau of internal audit, the meeting between the head of internal audit department and bureaus of internal audit, the knowledge sharing meeting.	
Participant-Observation	• (Same as above for direct observations) • Insightful into interpersonal behaviour and motives	• (Same as above for direct observations) • Bias due to investigator's manipulation of events
Physical Artifacts	• Insightful into cultural features • Insightful into technical operations	• Selectivity • Availability

Source: Yin (2003, p.86)

*Sources of evidence adopted in this study

The section below outlines the use of the multiple data collection method to collect empirical evidence.

3.6.1. Semi-Structured Interviews

Concerning interpretive case study, interviews are considered the most important source of information (Walsham, 1995a; Yin, 2003). In interpretive study, less structured interviews are recommended as they encourage the participants to express their opinion freely without being restricted by the researchers' preconceptions (Doolin, 1996). It is consistent with ontological stance of this research since such interviews explored the experience, understanding and interpretations of the participants as the component of social reality. Moreover, interview is also in harmony with the research's epistemology since it is an interactive approach which allows the flow of participant interpretations.

Hermanowicz (2002) suggests that the most fundamental type of interviews is the semi-structured interview as it enables the researchers to gain a closer understanding of people and their social world. In semi-structured interviews it is also appropriate to use the common open-ended question in interviews such as what and how (Eriksson and Kovalainen, 2008). Further, case study interviews are open-ended in nature since the researcher can ask respondents about facts and their opinion of certain matters or events (Yin, 2003). During the interview, the researcher records the participants' responses and transcribes them afterwards (Hermanowicz, 2002), and can complement this with note-taking if necessary (Walsham, 1995a).

Johnson and Christenson (2004, p.178) define interview as a data-collection method in which an interviewer (a researcher or someone working for the researcher) ask questions of the research participants. The interviewer asks questions related to the issue being investigated, while the interviewees provide answers based on their personal

knowledge or experiences. Interviews can be carried out in a number of ways: face to face or in-person interviews and telephone interviews. For this study, the researcher conducted face to face interviews which lasted roughly an hour and half for each participant. However, the telephone interviews were employed to ask for additional information. Johnson and Christenson (2004) emphasises the strength of using interviews in collecting data, is that it allows the researcher to use probes or prompts to obtain response clarity or additional information. In addition, biased views can be reduced by interviewing many different highly knowledge respondents who have the critical ability to show their views from different perspectives (Eisenhardt and Graebner, 2007).

Yin (2003) suggested using open-ended interviews during field research since it encourages research respondents to discuss issues and share their viewpoints. This study gathered the interviewees' interpretations concerning changes in the practice of internal audit functions in relation to government regulations, professional bodies and the uncertain business environment as the institutional pressures on a public SOE. Therefore, the interviewees were chosen to include 18 internal auditors from various positions; one manager-level auditor, five senior-level auditors, 11 middle-level auditors and one junior-level auditor. The total numbers of participants were 18 out of 22 auditors in the internal audit department under study. 4 auditors refused to participate in this study. Using multiple informants allows the viewing research points from more than one perspective and also verifies the credibility of data. Interviewing different people within an organisation aims to triangulate subjects (Myers and Newman, 2007) and reduce the bias of interviewing only prominent individuals (Miles and Huberman, 1994). The information from the semi-structured interview comprises the functions of internal audit, how these functions operate, how human resources is managed, how the

internal auditors tackle their challenges while performing their duties, as well as the reasons for their actions. In addition, when a researcher finds that more information is needed, he / she can ask for permission to call back in order to clarify some information or to gain feedback (Myers and Newman, 2007).

An interview protocol of this study was guidance for the interviews, and was developed prior to the field study, including being reviewed and checked by three supervisors have expertise in internal auditing and institutional theory. The protocol draft was given to three supervisors who have expertise in internal auditing and institutional theory for comments. Johnson and Christenson (2004, p.180) defines an interview protocol as an instrument to collect data in an interview which includes the items, the response categories, the instructions and so forth. However, there will be no response categories in this interview as it is a qualitative interview with a list of open-ended questions to obtain qualitative data (Johnson and Christenson, 20004, p.183). The protocol provides a description of procedures for the interview purposes. The protocol contains the purpose of the research, data collection methods, data analysis, the unit of analysis of the study, questions on the general information of the organisation, questions regarding personal information of the participants and questions that relevant to the research topic. The three supervisors were asked to review whether the protocol was in line with the objectives of the study and provide required information for the participants to provide the required information for the researcher. The supervisors also provided advice on the ways to conduct the interview with the research participants. Such protocol allows other researchers to trace the data collection path used (Irani *et al.*, 1999), replicate the study and obtain similar results (Yin, 2009).

The interview session is initiated by providing a participant information sheet (PIS) and a consent letter to each of participant. The PIS and consent letter are written

in English. However, with the advice of the supervisors, the researcher explained the content of these to the participants in Indonesian language. In addition, the internal audit manager who is fluent in English provided explanation about the content of the PIS and consent forms in Indonesian language to his subordinates who participated in the study. In this interview session, the researcher informed the participant in Indonesian language about the aim and general objectives of the study, the purpose of the interviews, and how the information gathered in the interviews are presented in the thesis. At this point, the participants were assured the confidently of their identities in all the research documents.

During the interview process, the researcher avoided over-directing the interviewee and allowed the interviewees to express their views freely. All interviews were conducted in the interviewee’s office within the department of internal audit, and this facilitated access to relevant documents to support their views. The initial English interview questions and their Indonesian translations were checked by one of the supervisor who is a native Indonesian fluent in Indonesian and English languages. All interviewees answered the interview questions in a mixture of Indonesian and Javanese (local) languages. The researcher recorded interviews using an audio tape recorder and then converted the recordings into transcriptions in Indonesian language by listening to the recordings repeatedly. The transcriptions were then checked by the researcher listening to the recordings again. In order to increasing the credibility of the interview data, these transcriptions were sent to the participants for final confirmation as Bryman and Bell (2007) suggest that members’ validation is essential to confirm the collected data. These transcriptions were then translated into English language by a certified translator. The English transcriptions were then checked by the supervisor who is fluent

in English and Indonesian languages by comparing them with the transcriptions in Indonesian.

3.6.1.1. Purposive Sampling for Participants

Many researchers highly recommend the use of purposive sampling techniques in qualitative research (Neuman, 2003), to identify the key participants. In such a sampling technique, it is the researcher's self-interest which develops or specifies the criteria for the research participants (Johnson and Christensen, 2004, p. 215), and the main criterion is having a detailed understanding of the phenomenon under study. For instance, in this study, the participants' profession as internal auditors in a public SOE is mainly used to determine the criterion of being participants in the research. This criterion is set up because the unit of analysis was the internal audit unit which covers individual internal auditors, who are in a position to respond to institutional pressures in undertaking internal audit activities. The internal auditors enabled the researcher to explain the research phenomena. Further, Yin (2003) suggests careful selection of participants as they play a vital part in interview, and they should be integrated in the case study protocol.

3.6.2. Direct Observations

Along with interviews, data was collected through the observation of a number of internal auditors in their departments, to observe the interaction between internal auditors as well as between the auditors and the auditee. Observation comprises of activities like listening, looking, and everyday face-to-face interactions which greatly depend on both verbal and visual behaviours (Punch, 1999). In some cases, internal auditors, can demonstrate practically how they, for example, undertake the internal audit plan activity, and sharing knowledge for training purpose. All these actions will be observed as they add to data richness and as Yin (2003) highlights, a researcher can

observe relevant behaviour or available environmental conditions. In qualitative research, observation is unstructured as recommended by Bryman and Bell (2007).

As noted previously, triangulation involves multiple used of data collecting methods, and observation is employed in order to optimise the triangulation to obtain data enrichment as well as increase research validity and reliability. Observations in this study can involve observations of meetings between the internal auditor team, and between the internal audit staff and both the audit committee and top management. Moreover, researcher will observe the condition of workspaces as they indicate an organisation's working climate. In addition, while carrying out observation, some efforts to converse informally with the internal audit staff were conducted for additional information.

Observation was found to be a useful method of collecting data, instigated by the need to investigate the working environment, the communication between partners, and the means of interaction. A number of relevant behaviours or environmental conditions will be available for observation within the phenomena under study (Yin, 2003). Such observations provide an added source of evidence in a case study. Ultimately, the technique of observation was employed to obtain maximum benefit from triangulation in this study, which resulted in enriching the gathered data and increasing the research reliability and validity.

Moreover, informal conversations among the internal auditors offer opportunities to gain additional information about the area being studied. Similarly, the meetings between the internal auditor team and the audit committee represent other information sources that can be obtained through observations.

3.6.3. Documentation and Archival Records

For case studies, documents are important to corroborate and augment evidence from other sources (Yin, 2003: p. 87). Yin (2003) further explains that documents can be used to make inferences, and be used as clues worthy of further investigation. The overall value of documents indicates its explicit role in any data collection for case studies. Therefore, systematic searches for relevant documents are an essential aspect of the data collection plan (Yin, 2003).

In qualitative studies, collecting documents is deemed a crucial means of data collection. Documentation and archival records strengthen research and provide information that may not be available from other sources (McDonald, 2010; Yin, 2003). Documentation includes “administrative documents, formal studies or evaluation and newspaper clippings” (Yin 2003, p.86). The documentation in this study will cover:

- All government regulations relating to the internal audit, for example: Bapepam-LK/OJK regulation for listed companies, the Decree of Ministry of SOE on corporate governance for all SOEs, the Law of SOE and other relevant government regulations for SOE.
- The internal audit charter, the independent audit reports generated by the BPKP and the consultant firms, the annual report of SOE.
- The company policy, the organisational structure, all Standard Operating Procedures (SOP) documents of internal auditing, Internal Audit Plan, knowledge sharing materials from internal audit training sessions, and other relevant documents, such as the book of International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA), the Professional Standards of Internal Auditing published by the Consortium of Professional Organisation of Internal Audit in Indonesia.

- In order to corroborate the evidence from other sources, this study also provides data from the organisation's website and other public sources of information, such mass media.

These data assist to develop rich knowledge concerning the phenomenon being investigated.

3.7. Data Analysis

Data analysis methods are often not well formulated is one of weaknesses of using qualitative data (Miles and Huberman, 1994) and most methods require skills of the researcher to observe themes within data (Oates, 2006). Some researchers have suggested that qualitative content analysis can be used to analyse the significant amount of qualitative data (Miles and Huberman, 1994; Yin 2009; Zhang and Wildemuth, 2009). Qualitative analysis consists of "three concurrent flows of activity: data reduction, data display, and conclusion drawing / verification" (Miles and Huberman, 1994: p.10). This study applied the ideas of Miles and Huberman's (1994) as a general strategy and a qualitative content analysis suggested by Zhang and Wildemuth (2009).

3.7.1. Qualitative Content Analysis

This study employed a qualitative content analysis technique in order to understand the nature of the investigated phenomena and to interpret the themes of the research participants. This technique preserves the deep meaning of the qualitative data, and provides a holistic view of the phenomena through the interpretation of all transcribed interviews, documents and observation.

Content analysis usually refers to a systematic and replicable technique for compressing words of text into fewer content categories stemming from clear rules of coding (Krippendorff, 2004; Weber, 1990). Content analysis interprets the meaning from the content of text data. Patton (2002, p.453) defines qualitative content analysis

as "any qualitative data reduction and sense-making effort that takes a volume of qualitative material and attempts to identify core consistencies and meanings". Content analysis enables researchers to understand social reality in a subjective but scientific manner (Zhang and Wildemuth, 2009).

Qualitative content analysis typically uses an inductive approach, in which themes and categories are obtained from the data (Zhang and Wildemuth, 2009). However, the deductive approach is not excluded from qualitative content analysis (Patton, 2002). Using inductive reasoning, there are three approaches to qualitative content analysis (Hsieh and Shannon, 2005). This study follows the approach of qualitative content analysis, whereby a theory and relevant research findings are used as the basis for initial coding. Then, during data analysis, a number of new codes may arise from the data. This method is employed since it validates a conceptual framework (Hsieh and Shannon, 2005). This approach directs the analysis and interpretation with particular expectations, while empirical data may reveal some new aspects which differ from facets within the conceptual framework.

3.7.1.1. Prepare the Data

In the analysis process, data collected from multiple sources were handled concurrently rather than separately. Every data source has an important role in providing a greater understanding of the entire phenomenon and in reinforcing the research results. The process of data analysis began with data being converted into written text. Recordings of interviews using audio tapes were transcribed. Comprehensive transcripts contain all the answers to the interview questions which were transcribed literally in as spoken. The transcribing process includes the translation process from Indonesian to English. A copy of all raw data was created. The first step of

analysis was reading all the data to identify its key themes. At first, three themes were employed (Oates, 2006):

a) Themes have no relation to the aims of the research so are not required.
b) Themes furnish general information which is needed for explaining the research context. For instance: the organisation history, and the number of employees.
c) Themes were pertinent to the research questions. These themes are coded and categorised.

3.7.1.2. Define the Coding Unit

In the qualitative content analysis, defining the coding unit is one of the most fundamental and essential decisions (Weber, 1990). Zhang and Wildemuth (2009) maintained that the coding unit of analysis means that the basic unit of text has to be classified. To do qualitative content analysis, individual themes are used as the coding unit of analysis instead of words, sentences or paragraphs. A theme can be represented by a single word, a phrase, a sentence, a paragraph or the whole document. In other words, a text chunk of any size can express a code as long as the chunk represents single theme of an issue relevant to the issue being investigated.

3.7.1.3. Developing Categories and a Coding Scheme

In the Miles and Hubermen Framework (1994), data reduction occurs continually throughout the analytical process (Punch, 1999). Miles and Huberman, (1994, p.10) define data reduction as “the process of selecting, focusing, simplifying, abstracting, and transforming the data that appear in written-up field notes or transcriptions”. The objective of data reduction is to “reduce the data without significant loss of information” (Punch, 1999). Further, Punch (1999) classifies the form of data reduction activities in three stages: early, middle and final. In the beginning stage, data reduction happens through editing, segmenting, and summarising data. In the middle stage, it happens

through "coding and memoing and associated activities like finding themes, clusters and patterns"(p.203). Johnson and Christenson (2004) define memoing as writing memos or recording reflective notes about what the researcher is learning from the data. At this stage, the researcher tries to develop the categories and a coding scheme. A category is defined as "a group of words with similar meaning or connotation" (Weber, 1990, p37). In the final stage, data reduction occurs by conceptualizing and explaining as developing an abstract concept is also a way of data reduction (Punch, 1999, p. 203). Hsieh and Shannon (2005) point out that analysis starts with developing initial codes based on the conceptual framework. The coding scheme and categories are developed into themes and sub-themes.

Rowley (2002) points out the importance of developing a framework to be used as an analytic strategy for organising a case study. The framework development should reflect the themes and the collected evidence within each theme is analysed and compared in these categories. Rowley further suggests that the purpose of doing this is to get a description that can be corroborated from multiple sources of evidence. The coding scheme and categories were based initially on the conceptual framework themes and sub-themes. This approach was indeed helpful for the data reduction stage. This process is also directed towards the research questions and objectives. Moreover, Miles and Hubermen (1994) suggest that coding should be based on the conceptual framework and research questions since they are the best defence against overload. Miles and Hubermen (1994) also indicate that a list of coding categories should be generated from the framework and modified during the analysis as new categories emerge inductively. Assigning a unit of text to more than one category simultaneously is applicable in qualitative content analysis (Zhang and Wildemuth, 2009). The definition of coding

scheme categories is directed to be as internally homogeneous as possible and as externally heterogeneous as possible (Lincoln and Guba, 1994).

3.7.1.4. Test the Coding Scheme on a Sample

At early stage of the analysis process, the researcher developed and validated the coding scheme in order to use a standardised process of analysis. Afterwards, coding consistency was checked through an inter-coder agreement assessment. A sample data was coded to test the clarity and consistency of category definitions (Zhang and Wildemuth, 2009). Weber (1990) mentions that the process of coding sample text, checking coding consistency and revising coding rules is iterative, which continues until the achievement of sufficient coding consistency.

3.7.1.5. Code all the data

The coding rules were applied after sufficient consistency has been achieved. Also, there were repeated checks during the coding process. When new themes and concepts were revealed, they were added to the coding scheme.

3.7.1.6. Assess Coding Consistency

Having coded the entire data and rechecked the coding consistency, the researcher carried out a further check.

3.7.1.7. Draw Conclusions from the Coded Data

This step comprises the process of making sense of the themes or categories identified and their properties. The data are used to derive meanings which are then inferred and reconstructed. Exploration of properties and dimensions of all categories is done to identify relationships between categories. Perry (1998) stressed that the key to rigorous analysis of case study data was theoretical replication. One of the strategies to

analyse case studies, as recommended by Yin (2009) is to analyse the evidence based on the development of a case description technique.

3.7.2. Within-Case Analysis

Some scholars (Miles and Huberman, 1994; Yin, 2009) suggest that within-case analysis is the analysis of each individual case by comparing it with the research's frame of reference. For each case it is necessary to collate participants' individual responses to each question to facilitate comparative analysis, and to make a case summary, which is a single document created for each case and used to facilitate the production of case reports. Ultimately, within-case analyses, transcripts and response summaries are useful data.

3.7.3. The Role of Theory

In interpretive case study, theory is used in the early steps to formulate an initial conceptual framework. Walsham (1995a) mentioned that the framework considers the previous insights and forms a rational theoretical basis to inform the empirical work. The study used institutional theory to investigate the practice of internal audit functions as responses to government regulations, professional bodies and an uncertain business environment as the institutional pressures. The study investigated how the changes in the internal audit functions give it acceptance and legitimacy as a profession. Ball (1989) pointed out that institutional theory is relevant to understanding the effects of an institutional environment to internal auditing. The theory has been used to study internal auditing with a focus on the design of internal audit departments as well as the effectiveness of internal auditing (Al-Twaijry *et al.*, 2003, Arena *et al.*, 2006, Arena and Azzone, 2007, Mihret, 2012). However, there is no research on the practice of internal audit functions focusing on comprehensive practice of internal auditing. The theory also

offers a good conceptual basis for studying the practice of change shaped by institutional environments.

This study uses institutional theory as its base in interpreting the research findings. Perry (1998) highlights the essential role of theory in case study design and data analysis. Creswell (2009) also places case study in the middle of the continuum on how theory is used in qualitative research approach. Further, this study uses a single-case study to investigate the practice of internal audit using the institutional theory as a research framework.

3.7.4. Criteria for Finding Trustworthiness

Despite the existence of criteria for finding trustworthiness in quantitative research like objectivity, reliability, internal validity and external validity, these criteria, are not applicable to interpretive research (Díaz Andrade, 2009; Lincoln and Guba, 1986). Therefore, for interpretive case study, different criteria have been set (Morse *et al*., 2002) although there is no agreed set of criteria. The criteria for interpretative study as postulated by Guba and Lincoln (1994) include: trustworthiness (validity), confirmability (objectivity), dependability (reliability), credibility (internal validity) and transferability (external validity).

3.7.4.1. Credibility

Guba and Lincoln (1994) define credibility as the extent of results' accuracy, matching reality and measuring it correctly. It parallels validity in quantitative research. Credibility is ensured by adopting a number of techniques. It is vital to ensure that the research is well designed so that it can examine the right things and collect the right data from the right source. In order to collect the right data for the study's purposes, the researcher asked three supervisors who are experts in internal auditing and institutional theory to check and review the interview questions. Offering an explanation on what

happens concerning the relationship and the reasons underlying them is also an essential aspect of research validity (Eisenhardt, 1989). Further, the researcher prolonged her stay in the SOE in order to observe the participants' behaviour. This is important to become familiar with their routines and any unusual events. This extended engagement enabled the researcher to gain an in-depth and comprehensive understanding (Morse *et al*., 2002) of the internal audit functions practice.

Credibility can be increased by presenting some verbatim quotation as expressed by the participants. Lee and Lings (2008, p.237) indicate that presenting raw data collected from the fieldwork "allows the reader to get a better picture of the respondents' own concepts and categories, without relying solely on the interpretation of the researcher". This research also takes into account the participants' comments as a way of increasing credibility as Bryman and Bell (2007) suggest that members' validation is essential to confirm the collected data. Not only does it allow the expansion of understanding, this technique allows the refinement and clarification of the understanding of the collection the data. This technique is applied after each interview by summarising the main points expressed by the participants for final confirmation.

There are other techniques that can be used to increase the research credibility. These include the use of triangulation and relying on information from multiple respondents for semi-structured interviews. These techniques enable the researcher to see a particular aspect of research from more than one point of view (Morse *et al*., 2002). This study used triangulation on data collection methods; interview, documentation and observation, which resulted in triangulation on data evidences. In term of interview, the researcher involved various positions of internal auditors in the internal audit department. One technique to increase research credibility is undertaking peer debriefing process (Lincoln and Guba, 1986). This process involves colleagues acting as

external reviewers to share data collected in order to obtain different perspectives about the data. This also allows the researcher to broaden her / his interpretation of the data and to avoid biased explanations by asking a qualified peer to challenge the primary assumptions the researcher has made.

3.7.4.2. Generalisability

Collis and Hussey (2009, p. 59) argue that generalisation is "concerned with the application of research results to cases or situations beyond those examined in the study". This definition has frequently led to the criticism of case study as case study results cannot be statistically generalised (Yin, 2009). However, the generalisation of the results is dependent on analytical generalisation (Yin, 2009). Researchers such as Orlikowski and Baroudi (1991) clearly indicate that interpretive research aims to gain a deep understanding of the phenomenon which can be used to inform other contexts of study. It does not aim to reach statistical generalisation. From an interpretive position, the validity relies on the plausibility of the logical reasoning used in describing the findings and in drawing conclusions from them (Walsham 1993). Therefore, the generalisation in this study is not statistical but analytical whereby the empirical findings of the case study will be compared with the established theory, which is institutional theory. Furthermore, Walsham (1995a) indicates four other types of generalisation of interpretive case studies: the development of concepts, the generation of theory, the drawing of specific implications and the contribution of rich insight.

3.7.4.3. Confirmability

Confirmability is a concept viewed differently by positivist and interpretive approaches. In the positivist paradigm, it concerns the state of the researcher being free from bias (Lincoln and Guba, 1994). However, as there are interactions between researchers and the participants, there might be influences which cause bias in

interpretive research. In other words, there is the potential of researcher subjectivity which may cause biased explanations. Therefore, Rowley (2002) stresses that it is vital to link data collection questions to research questions in order to reduce subjectivity. Yin (2009) also postulated three solutions to deal with subjectivity which comprise the use various sources of data, establishing a string of evidence and having key interviewees review a draft of the case study report. Confirmability can also be achieved by using multiple-data sources, methods and informants to verify the description as well as interpretations that have been used (Doolin, 1996; Lincoln and Guba, 1994). It is also suggested that the researcher provides sufficient explanation to judge whether the results do flow from the data in the setting (Lincoln and Guba, 1994). Doing this contributes to the trustworthiness of the analysis as Yin (2009) points out that auditors and any external inspection are able to track the development of ideas through trustworthiness procedures.

3.7.4.4. Dependability

Dependability refers to the accuracy and reliability of the research instruments (Oates, 2006), and can be achieved through documentation of procedures (Rowley, 2002). In other words, both the research process and data need to be well recorded or documented. Yin (2009) advises that developing a case study protocol and database are one way to record or document the research process.

To enhance the dependability of this study, all the research processes follow the standard process which is clearly guided by a case study protocol. For instance, the recorded data from the interview data is fully transcribed so that accurate interpretation can be ensured as much as possible. Also, the empirical data, collected from all the interviews and other documents, is stored in a systematically and logically ordered manner which is called a structured case study database. Furthermore, to make sure all

the processes of data collection and analysis are accessible for review, a digital format of data is provided.

3.8. Ethical Considerations

It is suggested that ethical issues is critical particularly in social research (Tilley and Woodthorpe, 2011; Myers, 2009). In this study, there is an imbalance of power between the researcher and the participant (Bell and Bryman, 2007) whereby the researcher has a weaker bargaining position. The power to define to what extent access and setting can be accessed by the researcher is defined by the senior participants, in particular the senior manager. The researcher has to gain consent from the participant to conduct the research. Securing research consent is by convincing the participants that they would benefit from taking part and by ensuring them that confidential information is protected. Further, both the researcher and the companies made an agreement concerning information restriction that clearly specifies what can be disclosed for the research purpose. The researcher also faces pressure to protect participants as well as the companies' confidentiality and anonymity to avoid harmful effects (Bell and Bryman, 2007; Tilley and Woodthorpe, 2011). Confidentiality is related to protection of the given information while anonymity concerns the concealing of the names and any identifying information of the participants involved. Therefore, the participants' identities were protected by using pseudonyms and removing identifiable information concerning individuals and the company in this study. Furthermore, any input and feedback provided by them were used for research purposes and kept in high confidentiality. Overall, this process allows participants to be open and frank in sharing their personal beliefs and experiences.

The researcher also provided a participant information sheet (PIS) explaining participants' rights, contributions, benefits and risks of the study. They were also asked

to sign the consent form, which stating their participation was on a voluntarily basis. The PIS and consent form also stated that they had the right to take part or to refuse to participate in the study without having to experience any harm in the future. They could also withdraw participation at any stage of the research along with any information they had supplied. Such a condition is in alliance with suggestions by Krathwohl (1997, p.212) concerning the code of ethics in the conduct of research with human participants stating that "informing participants about the nature of the study, and respecting their freedom to decline to participate in or withdraw from the research in any time". In the same tone, Payne and Payne (2004, p. 68) also argue that participants should "be enabled freely to give their informed consent to participate, and advised that they can terminate their involvement for any reason, at any time".

Furthermore, the researcher has to ensure the privacy and confidentiality of the information provided, and informed participants that tape-recordings would be stored securely in such a way that only the researcher could gain access to the data. Moreover, during the analysis of data, the researcher was aware of ethical considerations and made obvious efforts to maintain the objectivity of the research.

Ultimately, it is critical to address ethical considerations of doing the interviews. Myers and Newman (2007) identify some ways to do this which involve such things as: gaining approval from the research ethic committee and consent from the participants; treating the participants in such a way as to respect their knowledge, expertise, position, and time provision; maintaining the confidentiality and anonymity of the collected data and the informants' identities; and providing feedback to the participating organisation.

Chapter 4
A Historical Account of the Legislation
Related to the State-Owned Enterprises in Indonesia

4.1. Introduction

The institutional theory supports the idea that the evolution of internal auditing is shaped by the changes in government legislation. In Indonesia, the government legislation may affect the development of State-Owned Enterprises (SOEs) and the practice of internal auditing in SOEs. In addition, the establishment of SOEs in Indonesia is related to the independence of Indonesia after the era of colonialism. Therefore, it is important to understand the evolution of internal auditing specifically as implemented by SOEs in Indonesia.

The discussion on the development of SOEs is spread into three periods starting from the early years after independence which is called 'the Old Order (Orde Lama)' and was led by *Soekarno*. The second period is the period after the old era which is called as 'New Order (Orde Baru)' led by *Soeharto*. The third period discussed in this chapter is the Post-New Order era which is a transition era within a situation of political instability after *Soeharto* stepped down.

Many developments in the practice of internal auditing in SOEs are discussed in this chapter. The issuance of government regulations that affect the operation of SOEs and hence the practice of internal auditing by SOEs is also covered in this chapter. Finally, the chapter will be closed with a summary.

4.2. The Development of State-Owned Enterprises (1945 – 2015)

Indonesia was colonialised for many years by Portugal, Britain, the Netherlands and Japan (Baker 1991; Fettling, 2014; Frederick, 2012; Hendriks, 2012). Such a long sombre colonial period has been an influence on past and also current Indonesian economics, because when those invaders entered Indonesia, they brought along their own control over Indonesian economics with a wide range of distinct regulations, some of which have remained until now (Baker, 1991; Hendriks, 2012; Lindblad, 2003). To illustrate, throughout 350 years of the colonial era, the Dutch built their business around Indonesia (Baker, 1991; Hendriks, 2012; Lindblad, 2003). The Dutch government established a large number of banks and business entities, which operated under Dutch policies (Baker, 1991; Hendriks, 2012; Lindblad, 2003). This policy meant the Indonesian government had difficulty taking control of businesses during the early period of independence. The situation was also affected by the nature of a country, being an archipelago as well as having a huge population that contains distinct multi-complexes of ethnic groups, cultures and religions.

The process of how the Indonesian government took over SOEs from the Dutch government and how the SOEs were developed will be discussed in three periods. The first period, in the Old Order was considered the initial period of the formation of companies owned by government in Indonesia. This era was under an economic framework created by President *Soekarno.* The second period was the era of President *Soeharto* who developed the companies owned by government into three legal forms, namely *Perum*, *Perjan*, and *Persero*. The third period was the era after President *Soeharto* in which the government started to focus on improving the condition of the SOEs. The detailed development of the SOEs will be presented in three subsections below.

4.2.1. The Old Order Era (1945 – 1966)

The Republic of Indonesia proclaimed its independence on 17th August 1945 with *Soekarno* as the first president (Baker, 1991; Fettling, 2013; Fettling 2014; Lindblad, 2008). The independence proclamation was a huge opportunity taken as soon as the Indonesian government recognised the power vacuum that arose when the Japanese army had completely withdrawn from Indonesia due to its surrender to the Allied forces after Hiroshima and Nagasaki atomic bombing events. At the same time the Netherlands, one of the main allied forces, was still on the long trip to return to Indonesia with the purpose of re-colonisation (Baker, 1991; Fettling, 2013; Frakking, 2012; Hendriks, 2012). As a result, the independence declaration was from the Indonesia government itself without any recognition by the Dutch government. This condition triggered battles across the entire territory of Indonesia (Baker, 1991; Fettling, 2013; Frederick, 2012); however, these wars were never successful in obtaining acknowledgement from the Dutch government. On the other hand, although the Dutch used violence to try and quash Indonesia's independence, the fact this is not only failed but also generated international criticism ended up forcing the Dutch and the Indonesian governments to hold a meeting to settle the problem peacefully (Baker, 1991). Therefore, in order that Indonesia's independence from the Dutch be acknowledged, the Indonesian government attempted to conduct many negotiations with the Dutch through a wide range of meetings, for example the Linggar Jati meeting in 1946 (Frakking, 2012), the Renville conference in 1948 (Fettling, 2014; Fettling, 2013), the Roem-Royen convention in 1949 and a Round Table conference in the same year (Lindblad, 2008; Wie, 2003). However, these meetings were not totally successful because the Dutch government affirmed political independence for Indonesia but not economic freedom (Lindblad, 2008). The Dutch government put pressure on the Indonesian government to sign the

Financial Economic Agreement in the Round Table conference that had both governments and the United Nations Commission in attendance (Wie, 2003). According to this Agreement, the Dutch wanted the Indonesian government to satisfy three key requirements (Wie, 2003). Firstly, the Indonesian government had to ensure the sustainability of the Dutch business's activities in Indonesia. Secondly, any Dutch companies could be nationalised only if such companies agreed and were considered to be in Indonesia's national interests. Thirdly, the Indonesian government had to commit to consultation with the Netherlands on any financial and economic policies that might affect the Dutch's economic benefits in Indonesia.

Undoubtedly, such requirements were extremely disadvantageous for Indonesia but the Indonesian government had no choice but to agree to let the Dutch take considerable control over Indonesian economics until the early 1950s (Higgins, 1990; Linblad, 2008). Nevertheless, the Indonesian government really understood that they could not have actual independence without having control of the economics of the country. Hence, the government planned to nationalise all foreign-owned companies that played vital roles in Indonesian economics by gradually purchasing them from the Dutch (Baker, 1991). For example, in 1947, a major oil refinery company and a strategic cement factory started to be managed and operated by Indonesian government (Lindblad, 2008; Zed *et al.*, 2001). In 1950, the Dutch airline company was purchased by the Indonesian government and became the very first airline company of the country and was named Garuda Indonesian Airways (Linblad, 2008; Wie, 2003). In 1954, the Indonesian government took over all four electricity firms across Indonesia (Lindblad, 2008). These companies had similar conditions and still hired foreign experts as employees for organisational management and operational purposes since Indonesia

lacked competent people. As a result, the entities operated under a Dutch management style as well as Dutch regulation.

Moreover, keeping in mind the aspiration of gaining control of all economic aspects for Indonesia, a variety of new state-owned enterprises were built up by the Indonesian government. For instance in 1946, two state-owned enterprises were created to manage the agricultural estates, called *Badan Penjelenggaraan Peroesahaan Goela Negara* (Body for Management of State Sugar Companies) and *Poesat Perkeboenan Negara* (Centre for State Estates) (Lindblad, 2008). In 1950, the government continued to establish the largest industrial project, namely the Gresik Cement Factory (Wie, 2003). In 1952, the government of Indonesia also established PELNI Company for inter-island shipping (Linblad, 2008). Interestingly, since the financial condition of the Indonesian government was not always good on the road to gaining economic freedom from the Dutch as it was purchasing and creating new enterprises, it came up with the solution of establishing joint ventures. By way of illustration, in 1952, the largest sack factory of Indonesia was a joint venture between the State Industry Bank (*Bank Industri Negara*), Dutch and two domestic plantations was established (Linblad, 2008). Implementing the nationalisation plan resulted in considerable foreign debt for the Indonesian government. Since the government had a serious financial shortage, the nationalisation plan was temporarily stopped between 1956 and 1957.

In order to legally support the continuous nationalisation plan as well as state-owned enterprises that had recently been taken-over or built, the Indonesian government started to issue a variety of laws throughout the three-year period from 1958 to 1960. In 1958, the Law No. 86 of 1958, the Indonesian government emphasised that they would take over any Dutch companies if necessary even without the agreement of those companies. Moreover, a nationalisation plan in terms of economics was carried out by

considering the Indonesian government as a sovereign government, so that it could give maximum benefit to the people of Indonesia, strengthen the country's security and protect the national unity.

In 1959 to 1960, President *Soekarno* imposed a politic system of guided democracy and guided economic to reduce the involvement of western capitalists and to build more of a relationship with Chinese socialists instead. In 1960, the Government Regulation No. 19 of 1960 was issued, which was associated with the essential need for establishing State Companies (*Perusahaan Negara*) in order to manage and implement all-important governmental economic projects. Under the Economic Guidance principle of President *Soekarno*, all State Companies had experienced similar management and control as well as shared the same legal form. Additionally, this law mentioned that the establishment of state enterprises aimed to build a better national economy.

It is necessary to notice that from 1960, it was Indonesian laws that were applied to the companies of State, rather than the law set up by the Dutch - "*Indonesiche Bedrijvenwet Staatsblad 1927 No. 419*". Importantly, regarding the control over of SOEs, the Regulation no. 19 of 1960 did not touched on any aspect associated with internal evaluation of a company's operation, which should have been performed by responsible internal auditors. Instead, audit activities of any company were performed by external parties who were members of the Supreme Audit Agency (BPK) and the Bureau of State Accountant.

In brief, the key motivation of the Indonesian government to establish the SOEs was to push rapid economic growth in order to increase the employment rate and to reduce poverty. Also, at the beginning of the independence period, building the necessary infrastructure was a priority because of its primary role in any country's development. In detail, there were two approaches used by the Indonesian government

to possess SOEs, one was by establishing new SOEs and the other was by taking over existing foreign companies through giving them appropriate financial compensation. Both methods required a huge budget that resulted in a considerable foreign debt for Indonesia. Another weakness of the Indonesian government at that time was the lack qualified native experts who could contribute effectively and efficiently in the enterprises already nationalised. Additionally, these SOEs were still affected by mimetic pressure because they still operated under the Dutch management style, with Dutch employees in various vital positions and they continued to be regulated by colonial regulations such as the ICW (*Indische Comptabiliteitswet*) which regulated managerial and financial accountability of the Republic of Indonesia and the IBW (*Indische Bedrijvenwet*) which standardised the financial administration of state enterprises (Burger 1975 cited in Wie 2003).

4.2.2. The New Order Era (1966-1998)

The history of Indonesia was divided into three main periods. The first, was called the Old Order. That period covered from the early years of independence in 1945 until 1966. The second era was named the New Order, which ran from 1966 to 1990. This period was indicated by a new political policy employed by the new government, and was marked by a shift from a tendency to be socialist to liberalism. Thirdly, the Post-New Order Era encompasses from 1998 to date.

4.2.2.1. 1966 - 1970

In 1966, the executive power was handed over from *Soekarno* to *Soeharto* (Baker, 1991). Afterwards, *Soeharto* became the second president of the Republic of Indonesia. In this era, *Soeharto* inherited a collapsed economy from the previous period (Baker, 1991; Panglaykim and Arndt, 1966). Serious corruption was present in every aspect of the governmental control system across the entire economy (Panglaykim and Arndt,

1966). In order to improve the national economy, the new President *Soeharto* drastically changed many policies to facilitate the shifting of Indonesia's political direction towards liberalism, rather than socialism (Baker, 1991). This meant that the government opened the door more widely for foreign investments in Indonesia. In 1967 the government obtained positive foreign aid, in terms of debt from the Inter-Governmental Group in Indonesia (IGGI) with a condition that the government must commit to implementing a liberal economy in Indonesia (Baker, 1991; Sadli, 1997). Taking this opportunity, in 1967, the government continued to attract foreign investors by issuing Law no 1 of 1967 on Foreign Capital Investment (Baker, 1991; Sadli, 1972). The presence of both foreign loans and foreign corporations was intended to improve the slumped economy of Indonesia by building infrastructure such as power plants, highways, ports, and industrial areas (Gie, 2011). Not only that, in the next year - 1968, the Law no 6 of 1968 on Domestic Capital Investment was released to attract domestic investors (Baker, 1991). Fortunately, the success of stabilising the economy was obvious and evident through the significant declining in the inflation rate (Baker, 1991).

Meanwhile, economic stability had been restored by implementing direct and indirect investment by the government in 1969 (Baker, 1991). Direct government investment was conducted in productive sectors of the economy, infrastructure and general services; while the indirect government investment was undertaken through the offer of subsidised credit by the state-owned banks as well as a great contribution from oil sector exports (Baker, 1991). As a result, economic growth during the 1970s was high.

The Indonesian government prioritised agriculture, food crops in particular, rather than manufacturing (Sadli, 1997), because the agricultural sector had played a major role in the Indonesian economy by contributing substantial national income, employing

a large proportion of the labour force and supplying raw materials for the manufacturing sector. For instance, plantations, which were wholly owned by the government, were allocated to 28 estates companies. As a result, under many new policies created by the government, Indonesia became the world's largest rice importer in 1970 and successfully transformed itself to be self-sufficient in rice production. Not only that, but Indonesia also became the world's major exporter of natural rubber, and palm oil (Baker, 1991). These achievements were mainly a result of the effective operation of 12 government-owned estates organisations that focused primarily on rubber products and 10 public plantation companies that produced palm oil.

Additionally, in 1967, the government evaluated the legal form of SOEs, which in the Old Order they had to follow the provisions of Guided Economic system mentioned above. The evaluation led to the conclusion that SOEs with different functions could not use alike legal form because it was considered causing an inefficiency of those SOEs' operation throughout the long period under the management of the first president. Instead, SOEs should be differentiated based on their main functions. Therefore, the President *Soeharto* decided to generate some stipulations in Presidential Instruction no 17 of 1967, which was also supported by the Government Regulation No.1 of 1969. According to the regulations, SOEs were divided into three forms, according to their different functions, namely Bureau Enterprise (*Perdjan*), Public Enterprise (*Perum*), and Limited Liability Company (*Persero*). Firstly, *Perdjan* was wholly owned by the government and constituted a part of Department/Local Government that focused on public services, such as trains and public hospitals. These services have been charging affordable prices thanks to government subsidisation. Secondly, *Perum* firms such as the Electricity Company and *Perum*, Forestry, were also fully owned by the government. However, in contrast to the first form, although the main function of *Perum* was also to

serve public interest, it has been operated for profit to ensure the sufficiency of governmental income. Similarly, *Persero* was profit orientated and operated to contribute to the development of private sectors and small business units, which *Perdjan* and *Perum* had not focus into those aspects yet. Interestingly, *Persero* included companies that were either fully or partly owned by government.

In terms of *Persero*, Regulation no 12 of 1969 was issued as guidance to how all *Persero* companies should be run. This regulation stated that *Persero* companies' activities were under the control of the Ministry of Finance, since *Persero* was mainly responsible for improving the government finances. To this end, President *Soeharto* also issued the Presidential Instruction No 11 of 1973, only for *Persero*. To illustrate, the Ministry of Finance represented the government as a shareholder in *Persero*, and had the right to delegate the authority to the technical Ministry as the supervisor of SOEs. The delegation was conducted in order to increase the efficiency and effectiveness of SOE activities. Thus, the technical Ministry had to provide technical supervision by giving operational direction and guidance to the board of directors, on matters such as production quality, production cost, and human resources.

Generally, the period between 1966 and 1969, after *Soeharto* had been appointed president of Indonesia, could be considered a positive period in Indonesian economics. Thanks to a wide range of new policies designed to attract more foreign investors, the high inflation rate was controlled and decreased effectively. Also, the agriculture industry got the necessary support from the government to grow and transform Indonesia from a rice importer to an exporter in only a decade. Importantly, SOEs operated more efficiently after the functional division and many supporting regulations were issued to re-define the administration and management style for each and every new form of SOE.

4.2.2.2. 1970-1979

This phase, after Independence Day, could be considered the golden period of the Indonesian economy. The strong economic growth was primarily supported by high revenues from the petroleum sector which benefited from the rising world petrol price from 1973 and beyond. However, the government seemed to pay such high attention to oil-related sectors that they were distracted from non-oil sectors. Possessing high revenues from the oil sector meant that the government had the ability to perform heavily direct and indirect investments (Baker, 1991). The increasing direct investments were mostly in infrastructure, public services and strategic industries through the establishment of a number of SOEs such as iron and steel (Krakatau Steel), aluminium (Asahan) and the development of existing SOEs, such as fertiliser (Pupuk Sriwidjaja Palembang), cement (Gresik) and oil refining (Pertamina) (Baker, 1991).

Besides, in 1976, the government, through the Ministry of Research and Technology, set up a state-owned company, PT Nurtanio Aircraft Industry, which in 1985 was renamed Nusantara Aircraft Industry. All these SOEs have similar features: they are capital-intensive and require long periods of time to provide benefits (Baker, 1991). There was also a great increase in indirect investment made by the government through giving subsidised credit to certain sectors through state-owned banks.

In 1976 the government established the Board of Trustees of Capital Market (*Bapepam*), which serves as a supervisor and manager of the stock exchange. Reactivation of the capital market was strengthened by the Presidential Decree no 52 issued in 1976. However, the capital market did not develop as expected because the stock market experienced a decline over a span of 10 years from 1977.

4.2.2.3. 1980

Right after the golden period, the Indonesian economy faced a slump with many difficulties. In 1980 the world economic deterioration resulted in a decrease in export revenues and an increase in the foreign debt burden on the government. In 1982, world oil prices fell, which caused negative effects on oil export earnings which were the main source of the governmental budget. In such a bad situation, the government tried to shift its effort and budget to other export industries, but the world market prices for those industries' products also decreased in the early 1980's, which negatively influenced foreign exchange earnings (Baker, 1991). Faced with this negative situation, the Indonesian government realised that they could not rely only on the public sector, but they should offer various advantages to the private sector to encourage them to contribute to the growth of the national economy. Therefore, the government issued a variety of policies associated with capital markets, the banking sector and the increasing roles of private companies in Indonesian industries (Wie, 1992). These policies reduced the roles of state-owned industries and increased the roles of private organisations in terms of both local and foreign companies in a wide range of industries (Bapepam, 2015). Moreover, those financial difficulties forced the government to sell some sound SOEs in order to get cash quickly (Bapepam, 2015). Although Gresik Cement Company was considered to be the most profitable company, it was the very first SOE whose shares were sold to the public.

Furthermore, in order to improve the performance of SOEs, in 1983, the government issued Government Regulation no 3 of 1983 which regulated the guidance and supervision of three legal forms of SOEs, namely *Perdjan*, *Perum* and *Persero*. The guidance was carried out by specifying particular plans, implementation and evaluation of SOEs' duties and functions. The evaluation could be conducted by comparing the

results from the implementation with specific targets set in the plan in terms of both financial and operational aspects. It was this regulation that commenced the setting up of the internal control unit which is now recognised as the internal audit unit.

In 1988, the Presidential Instruction No 5 of 1988 was issued to provide guidelines on how to improve soundness and management, which were controlled by the Finance Minister as the government treasure counsellor and also the shareholder of SOEs. To follow up on the president instruction, then, in 1989, the Finance Minister released the Finance Ministry Decree No 740/KMK.00/1989 and No 826/KMK.013/1992 on improving the efficiency and productivity of SOEs. The regulation stipulated that the assessment of efficiency and productivity of the SOE should be conducted in the form of a periodic performance evaluation based on the management report and financial statement. The result of performance appraisals of SOE allowed the determination of the soundness level of SOEs, such as very sound, sound, less sound and unsound. The financial ratios, consisting of profitability, liquidity, and solvency were used in the soundness appraisal of SOEs.

However, despite the government's efforts to improve the performance of SOEs by issuing several regulations on performance evaluation and financial soundness standards, it did not achieve the expected results. Consequently, the SOEs could not contribute much to the national income as many SOEs suffered financial losses. This occurred because the management of SOEs was unprofessional, non-transparent and also much corruption happened mainly in SOEs and in specific government departments, such as the Taxation Office, Public Works and the Police Service (Brown, 2003).

In this case, the government assisted the unsound SOEs to recover by using funding from the non-budgetary expenditure of government. However, a problem emerged since such funding was also handed out to corporate crony businessmen to

subsidise and protect their businesses, which increased the government spending (Nasution, 1995). It was collusion between political power holders and their business cronies, nepotism, and the corruption of public funds (Wie, 2001). The cronies included *Soeharto*'s children and heads of conglomerates who owned and controlled numerous companies, such as banking, real estate, manufacturing and export-import (Brown, 2003).

These management approaches created a situation of dependence of SOEs on the government. It made them become burdens on government and meant they had difficulty in achieving efficient operating patterns (Brown, 2003). Furthermore, the approach resulted in the failure of SOEs to compete with private enterprises since they offered products with high prices due to high cost of production.

4.2.2.4. 1990s

In 1991, the government undertook a privatisation programme by selling SOEs' shares to the public to obtain quick income for the budget. During 1991-1999, President *Soeharto* and President *Habibie* privatized 10 SOEs through the capital market and invited investors who had potential as strategic partners (Aliya, 2015).

In 1997, Indonesia was hit by the Asian crisis which had an impact on Indonesian currency which dropped from Rp2400 to Rp17500 per US dollar. It was believed that the government had no capability to bring Indonesia out of the crisis (Brown, 2003). In early 1998, the deteriorated economic crisis triggered increasing student demonstrations. In the meantime, in March 1998, *Soeharto* was elected the President of Indonesia for a seventh term and established the Ministry of SOE. Along with the establishment of the Ministry of SOE, the position, duties and authority of the Finance Minister as shareholders at the *Persero* was transferred to the Minister of SOE, except for some SOEs which were set by the Presidential Decree. This transfer of responsibility was

intended to improve the performance and efficiency of SOEs, as contained in the Government Regulation No. 50 of 1998 as well as the Presidential Instruction No. 15 of 1998.

At the end of *Soeharto*'s era, the Asian crisis hit Indonesia and resulted in the decline of Indonesian's economy; an increase in the budget and spending of the government, the burden of foreign debt maturities, the fragility of monetary economic stability, and political instability (Wie, 2001). Wie (2001) further explained that the various government policies which were intended to provide more protection to conglomerates also increased the burden on the government. All these circumstances forced President *Soeharto* to ask the International Monetary Fund (IMF) for help to overcome the crisis. This action resulted in the involvement of IMF in determination monetary and economic policy in Indonesia, including implementation trade liberalisation and privatisation of SOEs (Nurfitriani, 2012; Wie 2011). Obviously, the crisis meant the Indonesian economy depended on foreign aid as well as foreign capital. On May 1998, *Soeharto* formally resigned as Indonesia's President.

During the New Order era, the SOEs had been fully controlled by the Indonesian government, operated by Indonesian employees and regulated by Indonesian law. However, the SOEs still hired foreign consultants for certain positions in the organisation due to there being no capable Indonesian employee for such positions. Also, some SOEs had joint cooperation with foreign companies. Such conditions indicate that management of SOEs was still influenced by mimetic pressure. Additionally, since the SOEs were funded by the Indonesian government and controlled by the Indonesian law this means the SOEs have to conform to Indonesian law. This situation points to the fact that the SOEs were shaped by coercive pressure.

4.2.3. Post – New Order Era (1998-2015)

During 1998 to 2015, the Indonesian government was led by four presidents: *BJ Habibie*, *Abdurrahman Wahid*, *Megawati* and *Susilo Bambang Yudhoyono* (*SBY*). *BJ Habibie* was elected to replace *Soeharto* as Indonesian president. He presided over the government from 1998 to June 1999. He took over the president position when a serious economic crisis was occurring - the Indonesian currency, the rupiah, slumped against the US dollar, foreign debt increased, inflation was at a high rate, economic growth was negative, 90 per cent of major companies in Indonesia were bankrupt, many banks were closed and various constructions stopped (Brown, 2003). *BJ Habibie* carried out a number of actions to overcome the crisis. First, in banking sector, in 1999, *BJ Habibie* issued Regulation No. 17 as a basis to establish the National Bank Restructuring Agency (BPPN). Second, he ratified the Law No. 5 of 1999 to prohibit monopolistic practices and unfair competition and also introduced Act No. 8 of 1999 on consumer protection.

In 1999, *Abdurrahman Wahid* was voted president and took the position between 1999 to 2001. In 2000, the president established a Ministry of State that was responsible for capital investment and development of SOEs. With the establishment of this new Ministry of State, the authority and duties of the Minister of Finance as a shareholder of *Persero* was transferred to the new minister of state, except for banking, insurance, other financial services and trains. The requirement of transfer was contained in Regulation No. 98 of 1999 which then amended by Regulation No. 48 of 2000. *Abdurrahman Wahid* was dismissed in 2001 as an Indonesian president by People's Consultative Assembly.

In 2001, *Megawati* was chosen as president of the Republic of Indonesia for the years 2001 to 2004. She decided to separate the Ministry of State for SOEs from capital

investment. This decision was followed by issuing the Regulation No. 64 of 2001. The regulation required the authority and duties of the Minister of Finance in *Persero*, *Perum* and *Perjan* to be transferred to the Minister of SOE. In 2002, the Ministry of SOE released a regulation on the implementation of Good Corporate Governance (GCG) in SOEs, which was contained in the Decree of Minister of SOE No KEP-117/M-MBU/2002. The issuing of this regulation stemmed from two considerations. First, undertaking GCG was important to create a sound management system for SOEs. Second, the GCG was not fully implemented in SOEs. Additionally, this regulation also presented the internal control system and the internal audit. However, the item of internal audit was only briefly mentioned in the regulation. Moreover, in the same year, the Ministry of SOE also issued KEP-100/MBU/2002 as a legal basis to monitor the financial and non-financial performance of SOEs. The financial performance is measured using financial ratios, while non-financial performance is assessed in terms of efficiency and productivity. For this purpose, internal auditing may play an important role in creating and maintaining the soundness of SOEs. In 2003, the Law of SOE No. 19 of 2003 on the management and operation of SOEs was published. This law paid special attention to the establishment of an internal audit unit and to external auditing. In this case, the Audit Board of the Republic of Indonesia (BPK) was authorised to undertake audits of financial statements of SOEs. In terms of overcoming the crisis in Indonesia, President *Megawati* privatised 12 SOEs to cover the budget deficit and pay back most of the foreign debts. The privatisation policy was contained in the Decree of People's Consultative Assembly (MPR) No VIII/MPR/2000 and MPR Decree No XI/MPR/2000 as well as Law No 25 of 2000. Privatisation programme aimed to create sound SOEs.

In 2004, *SBY* proceeded to lead the Republic of Indonesia for two periods: 2004-2009 and 2009 - 2014. During this period, the Indonesian economy was able to withstand the global crisis in 2008. In this situation, the government proposed the privatisation of 44 SOEs for reasons of greater efficiency and profitability, but it was rejected by many parties (Anonym, 2010). In 2005, Regulation No. 45 of 2005 was issued as the technical instruction to implement Law No. 19 of 2003. The Regulation No 45 of 2005 described the duties and authorities of management of SOEs. The internal audit unit and its works were also contained in the regulation. In 2008, the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) published a Regulation No KEP-496/BL/2008 as a guideline to prepare the Internal Audit Charter. From 2009 to 2014, economic growth slowed down, influenced by the European debt crisis and a global economic slowdown. In this situation, however, the government gave subsidies rather than raise the fuel prices, which had an impact on increasing the deficit of the trade balance (Wanandi, 2014). In 2012, the Decree No: SK-16/S.MBU/2012 was issued by the Ministry of SOEs as a guide to assess and evaluate the implementation of GCG in SOEs. The internal auditing was a part of GCG aspects that had to be assed and evaluated.

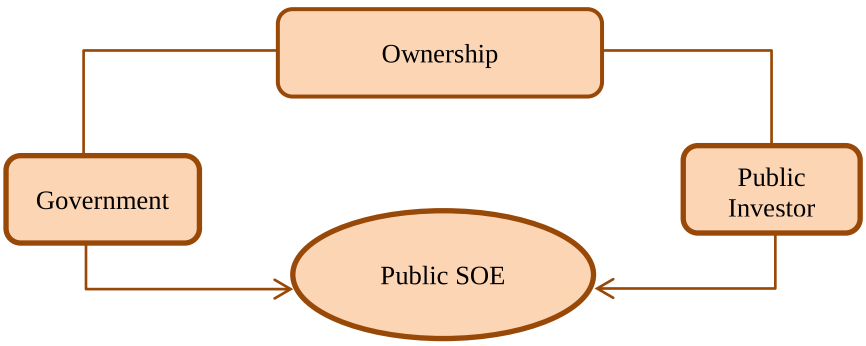
During the New Order era, the SOEs were privatised by Indonesian government through selling a percentage of SOEs' shares to the public. This action resulted in SOEs having to listen to business recommendations from the shareholder since they had rights regarding the SOEs. In this situation, the SOEs were influenced by mimetic pressure. Moreover, SOEs were affected by coercive pressure since they had to follow Indonesian law. Additionally, the SOEs were shaped by normative pressure since some government regulations, such as the corporate governance regulations published by the Ministry of

SOE, required the SOE to follow the International Standard of Auditing issued by the Institute of Internal Auditor (IIA) in terms of internal audits.

4.3. The Understanding of State-Owned Enterprise

The current definition of State-Owned Enterprise (SOE) is contained in Law No. 19 of 2003. SOE is defined as a business entity that is wholly- or majority-owned by government. The law describes two legal forms of SOEs: a fully government-owned enterprise (*Perum*) and partially government-owned enterprise (*Persero*). Furthermore, there are two types of *Persero*: unlisted *Persero* and listed *Persero*. However, all types of *Persero* must possess at least 51% of government shares and also be profit-oriented enterprises. The difference is that the listed *Persero* can sell its shares to the public. Therefore, the ownership of public SOEs consists of government and public investors as shown in figure 4.1. below.

Schema 4.1. The ownership of a public SOE (*listed* SOE)



As presented in Law No. 19 of 2003, there are four main roles of SOEs. First, SOEs contribute to the economy of Indonesia by providing income to the government. Second, the SOEs must meet public needs through producing high quality goods and services. Third, the SOEs undertake business activities that cannot be implemented by the private sector. Fourth, SOEs must assist small business and communities.

Furthermore, the Law No. 19 of 2003 regulates activities, management and control of SOEs. In terms of internal auditing, this law provides very broad guidance for

the internal audit unit. First, the SOE must have an internal audit unit. Second, the head of the internal audit unit is responsible to the CEO. Third, the top management explains the audit report to the board of directors. Fourth, the top management has to respond to the internal audit report.

To implement the Law No. 19 of 2003, the government issued Regulation No. 45 of 2005 as a technical instruction. Therefore, this regulation provides a more detailed requirement, including on the internal audit aspect. In this matter, the activities of the internal auditor are described in detail. First, the auditors carry out operational and financial audits. Second, the auditors must assess an internal control system. Third, the auditors deliver audit reports to the CEO. Fourth, the auditors monitor the follow-up of audit recommendations.

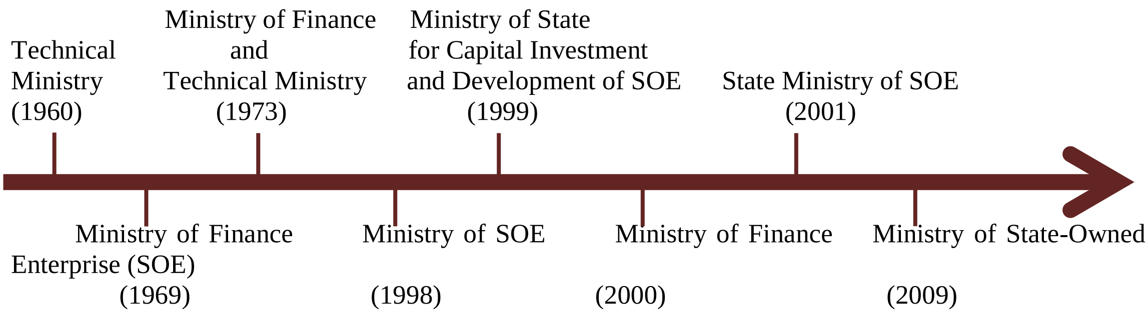
4.4. The Legal Institutions Context of Public SOEs in Indonesia

The legal environment in Indonesia can be traced to the Constitution of 1945 of the Republic of Indonesia. The Constitution is used as a basis for governing an administration system in Indonesia. The Constitution states that Indonesia is a democratic country with sovereignty in the hands of the Indonesian people. In this system of state, the Indonesian government is led by a president. The president has a right to appoint and dismiss the ministers who will preside over government departments.

The SOEs in Indonesia are under the responsibility of the minister. As presented in the previous subsection on the development of SOEs, there were some changes in the ministries who were responsible for the management of SOEs. The changes were presented in regulations from 1960 to 2009. These ministries consisted of the technical Ministry in 1960, the Ministry of Finance in 1969, the Ministry of Finance and the technical Ministry in 1973, the Ministry of State-Owned Enterprise in 1998, the

Ministry of State for Capital Investment and Development of SOE in 1999, the Ministry of Finance in 2000, the State Ministry of State-Owned Enterprise in 2001, the Ministry of State-Owned Enterprise (SOE) in 2009 to date (BUMN, 2015). The changes of the ministries are illustrated in figure 4.2.

Figure 4.2. The Ministries who are responsible for SOEs



These changes aim to improve both financial and non-financial aspects of SOEs, to enable SOE to increase their contribution to the national income. For this purpose, the SOEs must comply with regulations issued by the Ministry of SOE.

In addition, the Constitution 1945 also states that the responsibility for financial management of the government institutions and the SOEs will be audited by the Supreme Financial Audit (BPK). The audit results will be reported to the House of Representatives. The function of BPK in undertaking audit activities to the SOEs also is supported by the Law No. 15 of 2006 and the Law No. 15 of 2004.

Besides BPK being an external auditor of the government, there is an institution which acts as the internal auditor of the government. This institution is called the Financial and Development Supervisory Agency (BPKP). The functions of BPKP are contained in the Decree of President No. 192 of 2014. The establishment of BPKP aims to assist the government in carrying out internal oversight towards financial accountability in government institutions and the SOEs. In this case, the BPKP is the

coordinator of all internal audits of government's institutions as well as the SOEs. The BPKP reports to the President.

Public SOEs who are listed in Indonesian Stock Exchange (IDX) also have a responsibility to the Capital Market Regulatory Body (Bapepam) and the IDX institution. Bapepam serves to direct, control, and supervise the activities of the capital market as regulated in Law No. 8 of 1995. The Bapepam and IDX institutions are controlled by Ministry of Finance. In 2005, the Bapepam and the Directorate General of Financial Institution (DJLK) merged to create a new institution namely the Capital Market Supervisory Agency and Financial Institution (Bapepam-LK) as contained in Decree of Minister of Finance No KMK606/KMK.01./2005 (BapepamLK, 2006). In 2011, the Bapepam-LK was replaced by a new independent institution called the Financial Services Authority (OJK) as presented in Law No. 21 of 2011. The OJK regulated and supervised all activities in the financial services sector, such as banking, capital markets, insurance, pension funds, and financial institutions. The OJK is responsible to the House of Representatives (DPR). These changes are illustrated in figure 4.3.

Figure 4.3. The changes in the capital market regulatory body

The regulations released by the Bapepam-LK are still being used to date. Therefore, public SOEs must comply with all regulations published by the Bapepam-LK/OJK.

Additionally, the IDX is an institution that is responsible for executing trading of securities in Indonesia. The IDX resulted from a merger of the former Jakarta Stock

Exchange and Surabaya Stock Exchange. As public SOEs are listed in IDX, these SOEs have to follow requirements published by the IDX.

4.4.1. The Regulations on Internal Auditing Issued by the Legal Institutions Context of Public SOEs in Indonesia

As previously described there are five legal institutions in the context of public SOEs in Indonesia. They are Bapepam-LK/OJK, the Ministry of SOEs, BPK, BPKP, and IDX. Each of these institutions has issued a number of regulations which have to be observed by the SOEs.

4.4.1.1. The Regulation on Internal Auditing issued by the Capital Market Regulatory Body and Financial Institution/ the Financial Services Authority

The Capital Market Regulatory Body and Financial Institution/the Financial Services Authority (Bapepam-LK/OJK) issued a Regulation No: KEP-496/BL/2008 related to internal auditing for all public companies in 2008. This regulation aims to increase the effectiveness of risk management and corporate governance on public companies. For this purpose, the regulation requires all public companies to establish an internal audit unit and own an internal audit charter. The detailed requirements of this regulation are presented in table 4.1.

Table 4.1. The Regulation of Bapepam-LK/OJK on the Internal Auditing

Regulation of Bapepam-LK/OJK No: KEP-496/BL/2008
1. The public company is required to have an internal audit unit.
2. The numbers of internal auditors should be appropriate to the size and complexity of company
3. The public company must own the Internal Audit Charter which is set by the top management and approved by the board of directors.
4. The Charter has to set the definition of internal auditing and describe the functions of internal audits, assurance providers and consulting functions.
5. Code of Ethics of internal audit refer to the national or international Code of Ethics of Internal Audit
6. The structure and position of internal audit unit in public company: a. The internal audit unit is led by the head of internal audit. b. The head of internal audit is appointed and dismissed by the CEO and approved by the board of directors. c. The head of internal audit unit is responsible to the CEO.
7. The duties and responsibilities of internal audit unit:

a. Set an annual internal audit plan. b. Test and evaluate the implementation of internal control, and risk management in accordance with the company's policy. c. Examine and asses the efficiency and effectiveness of financial, accounting, operational, human resource, marketing, information technology and other activities. d. Recommend improvement and objective information on the activities being audited to all levels of management. e. Compose the audit report and deliver it to the CEO and the board of directors. f. Monitor, analyse, and report the follow up audit recommendations. g. Have cooperated with the audit committee. h. Set the programme to evaluate the quality of internal audit activities. i. Perform the special audit if necessary.
8. The authorities of internal audit unit consist of: a. Can access all relevant information of the company. b. Communicate directly to the top management, the board of directors, the audit committee, and their members. c. Have regular and incidental meetings with them. d. Coordinate its activity with the external auditor's activity.
9. Qualification of internal auditor: a. Has to have integrity, professional behaviour, independence, honesty, and be objective in performing their duties. b. Have knowledge and experiences of the audit technique and other relevant knowledge. c. Understand the capital market regulations and other legislations. d. To have communication skills. e. Obey Professional Standards issued by the Internal Audit Association. f. To keep confidential information and company's data related to the internal audit duties, except as required by legislations or court. g. Understanding the GCG principles, and risk management. h. Willing to increase their professional knowledge, skill, and capabilities continuously.
10. It is forbidden for internal auditors to work as operational staff in holding and subsidiaries companies.

4.4.1.2. The Regulation on Internal Auditing issued by the Ministry of SOE

The Ministry of SOEs issued a number of decrees. In 2002, the Decree of Ministry of SOE No: Kep-117/M-MBU/2002 was issued. The Decree regulated the implementation of GCG. There were some considerations on the issuing of this regulation. First, the GCG execution is crucial to create a sound SOE management system. Second, the GCG's codes were not yet fully applied in SOEs. Third, an optimal application of GCG's norms could increase the performance of SOEs. However, the regulation did not regulate the practice of internal auditing. Therefore, in 2011, the Ministry of SOE released a new Decree of Ministry of SOE No: PER-01/MBU/2011 to replace the previous decree on the operation of GCG, with a more complete requirement by adding the internal auditing aspect. Since the implementation of GCG needs to be evaluated and assessed, then, in 2012, the Decree of Ministry of SOE No SK-

16/S.MBU/2012 was published. This Decree provided a detail guideline to evaluate and assess the application of GCG at SOEs, including internal auditing. The items of internal auditing that are evaluated and assessed are presented in table 4.2.

Table 4.2. The Decree of Ministry of SOE on Internal Auditing

The Decree of Ministry of SOE No SK-16/S.MBU/2012
1. The SOE is required to have an internal audit unit.
2. The Charter is stipulated by the top management and approved by the board of directors.
3. The Internal Audit Charter has to contain: a. Items in line with Bapepam-LK/OJK Regulation and Company Law. b. Consideration of using the Professional Standards of Internal Audit issued by Indonesian Consortium of Internal Auditor or the International Professional Practices Framework of the IIA. c. Explanation of the position of the internal audit unit in an organisation, authorities of internal audit function which includes having access to all recordings, personals, and assets of company, and also defining the scope of the internal audit function.
4. The Charter has to be reviewed and up-dated if necessary.
5. Position of the internal audit unit is directly under the CEO in the organisational structure. The head of internal audit unit is appointed by the CEO and approved by the board of directors.
6. The head of internal audit has direct access to report to the audit committee.
7. The internal audit unit has to make a plan for the need of its auditor staffs. The numbers of internal auditors are appropriate to conducting the internal audit activities.
8. The qualities of internal auditors are appropriate to undertake internal audit activities. a. The head of internal audit must have capabilities that qualifies him as an internal auditor as certified by the professional association (Certified Internal auditor/Qualified Internal Auditor). b. The internal auditor staff possess knowledge, skills, and are also required to have appropriate professional certificates. c. There is a continual professional development programme for the internal auditor which aims to maintain professional certification and provide education support. d. Having proper quality of internal auditor professionalism
9. The internal audit unit must have audit guidelines, Standard Operating Procedures (SOP) and a supervisory role in the internal audit unit and assessment of quality assurance programme. a. The head of the internal audit unit sets the policy and procedures as activity guidelines for the internal auditor. Such policy and procedures should fit with the structure of the internal audit unit, its size, and also the complexity of the business activities of the company. b. The head of internal audit carries out a quality assurance programme which covers all aspects of internal audit activities. c. The internal audit unit must have a quality assurance programme which is assessed by an independent assessor every five years, who aims to evaluate compliance over the Charter, standards and code of ethics, efficiency and effectiveness of internal audit functions in fulfilling the stakeholders' needs.
10. The internal audit department sets annual internal audit plans and undertakes the audit activities as planned. a. The annual internal audit plan takes a risk-based approach. b. The annual internal audit plan is communicated to the audit committee to obtain recommendations. c. The audit plan has to be approved by the CEO and communicated to the top management. d. The accomplishment over the targets must be included in the annual audit plan.
10. The internal auditors report to the CEO and the audit committee. a. The QAR's report also has to be delivered to the audit committee.

11. The internal audit functions contribute to the corporate governance process, risk management and internal control improvement.
12. The internal auditors give recommendations on the business strategy of the company. a. The internal auditors evaluate whether the goals of the programmes and its operational activities are in accordance with the organisation's goals.
13. The internal auditors monitor the follow up of internal and external audit recommendations. a. The internal audit unit has guidelines for monitoring the follow up of the internal and external audit recommendations. b. The internal auditors record the results of monitoring activities. c. The internal auditors report the monitoring results to the CEO and the audit committee.
14. The internal audit recommendations can be applied and improve the operational activity.

4.4.1.3. The Regulation on Internal Auditing issued by Supreme Financial Audit of Indonesian Government

The Law No. 15 of 2006 gives authority for Supreme Financial Audit of Indonesian Government (BPK) to audit SOEs. This law describes further that the scope of audit activities covers financial audit, performance audit and specific audit. In conducting the audit activities, the law gives authority to BPK to obtain any information, data and documents as needed.

In a similar vein, the Law No. 15, 2004 grants authority to BPK to carry out financial audits. In undertaking a financial audit, BPK will also assess the implementation of the internal control system. In addition, verse 20 of the Law No. 15, 2004 regulates that the auditee (SOEs) must respond to the audit recommendation issued by BPK. There are legal sanctions to the auditee who refuse to provide data access as required by BPK or to follow up the audit recommendations.

4.4.1.4. The Regulation on Internal Auditing issued by Financial and Development Supervisory Agency

The Decree of President No 192 of 2014 regulates the duties of the Financial and Development Supervisory Agency (BPKP) in assisting the government to conduct internal oversight for financial accountability in government institutions, including SOEs. The Decree further states that the scope of audit activities comprises setting national policies on financial accountability in all government institutions, undertaking

an audit over the financial accountability, providing consulting services on the risk management, internal control and good corporate governance. The Minister of SOEs used an official letter, SE-14/MBU/2010, to instruct the boards of directors and the CEOs of SOEs to assess GCG implementation every two years and this must be conducted by BPKP as independent assessors.

4.4.1.5. The Regulation on Internal Auditing issued by IDX

The Indonesian Stock Exchange (IDX) issued a number of regulations. One of these is the regulation No Kep-306/BEJ/07-2004 that sets the requirements for public companies to provide audited annual reports and interim reports to the public. In this respect, sanction will be given to companies who are late in providing this information.

4.4.2. The Legal Environment and Professional Bodies of Internal Audit

The Constitution 1945 gives a right to the Indonesian people to communicate and obtain information to develop their personal and social life. The people also have a right to deliver information through any means. In terms of internal auditing, this legal environment supports the establishment of a number of professional bodies, such as the Indonesian chapter of the IIA, the Communication Forum of SOE's Internal Auditors (FKSPI), the Foundation of Internal Audit Education (YPIA), the Certification Boards of Qualified Internal Auditors (DSQIA) and the Association of Indonesian Internal Auditors (PAII).

The Indonesian chapter of the IIA was established in 1989. The formation of IIA Indonesia was aimed to advance the internal audit profession in Indonesia (iia-indonesia.org, 2016). FKSPI was founded in 1985. This organisation is specifically for all internal auditors in SOEs. The FKSPI is the communication forum for the internal auditors to share knowledge and experiences. The YPIA was built in 1995 and aims to increase the competence of internal auditors through providing training in internal

auditing. DSQIA is established in 2006. This organisation collaborates with YPIA in terms of providing professional certification after completing training courses. These five professional bodies of internal audit collaborated to produce the Indonesian Internal Audit Standards. For this purpose, they refer to the internal audit standards issued by the IIA.

4.5. Summary

Chapter 4 describes the development of SOEs and their legal environment context. The history shows that unprofessional management of SOEs had an impact on their performance. The poor performance of SOEs resulted in low financial contribution to the government. To overcome this issue, the government published a number of regulations which related to internal auditing. These regulations were released by five government institutions; Bapepam/OJK, the Ministry of SOE, BPK, BPKP and IDX.

In addition, the legal aspect also supports the establishment of professional bodies of internal auditing. This is indicated by the existence of five professional bodies: the Indonesian chapter of the IIA, Communication Forum of SOE’s Internal Auditors (FKSPI), the Foundation of Internal audit Education (YPIA), the Certification Boards of Qualified Internal Auditors (DSQIA) and the Association of Indonesian Internal Auditors (PAII).

Chapter 5
The Case: The Practice of Internal Audit

5.1. Introduction

The previous chapter presented a historical account of the legislation related to State-Owned Enterprises (SOEs) in Indonesia. This chapter provides the findings from the case study on the practice of internal audit at a public SOE, PT. Nusantara Sukses [1] (NS). The findings from the case study are presented using the case descriptions strategy suggested by Yin (2009).

As noted in chapter 3, this study used an interpretive worldview approach for the research inquiry where the phenomenon under study has to be understood by gaining the perspective of the participants, in terms of their experiences, understanding and interpretations of the phenomenon and then analysed using the appropriate theory as a guide. Therefore, the interview data and document analysis are the main sources of the findings.

This chapter depicts functions of the internal audit and their essential characteristics at PT. NS as the first multinational SOE in Indonesia. Briefly, there are three main functions of the internal audit, namely audit, consulting and catalyst. The functions have to be facilitated in order to provide professional services. The interview data and the internal documents indicated that three key factors had impacts on the professionalism of internal auditors: position, people and process. 'Position' describes the internal audit position in the organisational structure; 'people' refers to the human resources in the internal audit unit, whilst 'process' signifies the processes performed by the internal auditor.

[1] pseudonym

This chapter consists of six core sections which comprise the history of PT. NS, the internal audit department history, the internal audit unit, the position, the people and the process of internal audit, and also the summary.

5.2. The History of PT. Nusantara Sukses

The history of PT. NS can be traced back on the annual report of PT. NS. PT. Nusantara Sukses (NS) is the largest cement producer in Indonesia and is recorded as being the first multinational state enterprise in Indonesia with overseas subsidiaries. Currently, PT. NS controls 40.9 percent of the domestic cement market share, and has ten subsidiaries which engage in cement manufacturing, distribution and its utilisation.

PT. NS is a listed SOE. An intention to build this cement manufactory had existed since the Dutch Era. In 1935, Ir. Van Es a Geologist Dutch national discovered huge resources of limestone, used for making cement, in the Gresik area of East Java. He recommended the Dutch government build a cement factory in Gresik. In 1943, the Dutch government followed up his report by setting up a plan, however, the plan could not be realised because of the occurrence of World War II.

After independence, the plan was furthered by the Indonesian government. The vice president of Indonesia mandated to study in more detail the idea of establishing a cement factory. This project aimed to obtain more accurate geological data by involving two mining experts from Germany, Dr Laufer and Kraeff. In January 1951, they reported that the deposit of limestone was sufficient for a cement factory with a production capacity of 250,000 tons a year for 60 years. Afterwards, the Indonesian government made preparations to start the factory. On March 25, 1953, a legal entity, N.V. SG, was set up. In April 1955, the construction of the SG factory commenced. On August 7, 1957, *Soekarno* as president of Republic of Indonesia announced that the SG factory was operational and was designed to produce 250,000 tons of cement each year.

SG was the first cement manufacturer in the island of Java had crucial roles in supplying cement for construction. The establishment of SG was contained in the Government Regulation No 132 of 1961.

In 1960, the government issued Regulation No. 19 of 1960 concerning the State Company (*Perusahaan Negara*). Based on this regulation, the legal status of N.V. SG was changed to a State Corporation (PN). In 1966, the Old Era of government ended and the New Era of government began. The new regime of government published a new Regulation No 1 of 1969 which had an impact on the alteration of the legal form of SOEs. The SG as a SOE had to follow this regulation by officially transforming its legal status to a limited company (*Persero*) in June 1969.

In the early period of 1990, the government set up a program of privatisation by selling a maximum 30 percent of shares of SOEs to the public. This policy aimed to increase income to the state budget. This policy was developed because the government could no longer rely on the oil sector as a main revenue of the state. SG was the first SOE to be considered worthy of being privatised by selling a portion of government shares to the public. On July 8, 1991, SG was listed in the Jakarta and Surabaya Stock Exchanges and 40 million shares were sold to the public. The shareholder composition was 73% government, and 27% public. On September 1995, after the SG undertook a limited public offering (Rights Issue I) the stockholder composition became 65% government and 35% public. This action was performed because SG needed funding for expansion. In order to maintain the composition of government shares, the government then combined two other cement companies, namely SP and ST, into SG. On September 15, 1995, SG was consolidated with SP and ST and SG was the holding company, while SP and ST became its subsidiaries. This new consolidation of three cement companies was able to produce 8.5 million tons of cement every year. SP and ST are government-

owned cement companies which have strategic locations. SP is located in western Indonesia, while ST is located in eastern Indonesia.

On September 17, 1998, the government offered 14% of its shares in the SG in an open bidding which was won by Cemex SA de CV, a global cement company based in Mexico. The composition of share ownership was then Indonesian Government 51%, public 35%, and Cemex 14%. Later on September 30, 1999 the composition of shareholding changed again so that the Indonesian Government 51.01%, public 23.46% and Cemex 25.53%. On July 27, 2006, Cemex Asia Holdings Ltd. sold its shares to Blue Valley Holdings PTE Ltd., so the composition of shareholders was Indonesian government 51.01%, Blue Valley Holdings PTE Ltd. 24.90% and the public 24.09%. At the end of March 2010, Blue Valley Holdings PTE Ltd. sold all of its shares through a private placement, resulting in a shareholder composition of: government 51.01%, public 48.99%. On December 18, 2012, SG took over 70% shares of Thang Long Cement Joint Stock Company (TLCC) from Hanoi General Export-Import Joint Stock Company (Geleximco) in Vietnam with a 2.3 million ton capacity. With this action SG became the first multinational SOE in Indonesia. On December 20, 2012 the SOE grew into a strategic holding company and changed its name from SG to NS. At the end of 2012, its capacity for cement production was 28.5 million tons a year which comprised 26.2 million tons in Indonesia and 2.3 million tons in Vietnam. Furthermore, on December 24, 2013, NS established a new subsidiary, namely PT SG. In 2014, NS started to build two cement factories in Padan and in Rembang and founded PT SISI as a subsidiary in the information technology area.

5.3. The History of the Internal Audit Department

From the end of the 60's, NS owned an internal audit department called the internal control unit. In this period, the function of the internal control unit was in budget control through overseeing and evaluating the realisation of the budget. The unit of internal control was located under the commercial department and was on an equal level with other units under the department, namely marketing, procurement and financial administration.

From the 1960s to the end of the 1970s, the position of the internal control unit was firstly equivalent to the second echelon and then rose to the first echelon. In the early 1980s, as the company developed the internal control unit then changed to an internal supervisory unit (*Satuan Pengawasan Internal / SPI)*. This unit was placed under the top management. The unit has not yet been divided into bureaus, so all auditors have the same level as staff. The recording system was adapted from the Anglo Saxon Bookkeeping of Continental System to Accounting. Therefore, the company used new accounting principles in addition to changing the system that it followed.

In 2003, the SPI was converted into the internal audit unit. This unit was placed under the President Director of the company. The transformations of the unit of internal audit were associated with changes in business processes of the company and external influences, such as the Sarbanes Oxley Act 2002. In 2009, the internal audit changed its paradigm from watchdog to consultant and furnished the internal audit charter which regulated the governance of internal audit. In 2012, the unit of internal audit established three audit bureaus for task specialisation which consisted of audit bureaus of technique, accounting and finance, and also commercial and management systems. The main functions of the internal audit in the period up to now comprised auditing, consulting

and catalyst functions. In February of 2014, a new audit bureau was established, namely the ICT audit bureau.

5.4. The Internal Audit Unit

The practice of internal audit functions has changed since the new paradigm of internal audit function was applied in 2009. It started as a simple function as budget controller but now has three functions, namely assurance, consulting and catalyst. These changes were triggered by external factors as mentioned by an interviewee as follows[2]:

> *Changes in internal auditing paradigm are triggered by the development of internal auditing standards as well as the development of internal audit worldwide. And it seems that it is more appropriate for our circle to use the new paradigm, where the auditor position itself as partner of the auditee. It is better if we work as a partner, since partner could find solutions for auditee's problems.*

In similar vein, another interviewee described the reason for adopting the new paradigm as follows[3];

> *A transformation from watchdog to consultant and catalyst is a global paradigm in the area of internal auditing which we adopted later. I do not know the global reason of it. What I know, internal auditing face difficulties in using the old paradigm. Basically we have a good motive to help the enterprises to improve. But, when our role is watchdog we use a rigid approach to auditee which resulted in no cooperation from the auditees in terms of providing information to us. That is why we decided to follow the new paradigm by changing our roles to consultants instead of being watchdog.*

The interview demonstrated that factors triggering changes in internal audit functions encompass a new paradigm of internal audit initiated by the Institute of Internal Auditor.

The old paradigm had a number of characteristics which cover perceiving the internal audit as a watchdog, focusing on monitoring and looking for mistakes of the auditee by using a policeman style approach. In this case, detecting problems is the

[2] Interview with D, a middle-level auditor, at 21 October 2014
[3] Interview with P, a junior-level auditor, at 25 September 2014

main goal, whereby a number of audit findings are an indicator of success for the audit activity rather than following up audit recommendations by the auditee. All these features of the old paradigm created a negative attitude of the auditees toward the internal auditor as the auditees feel their career is threatened by the presence of the internal auditor. This condition resulted in auditees not accepting well the presence of an auditor which may create difficulty for the auditor to obtain the necessary data as well as delve into problems that have occurred in the unit of the auditee. This situation was mentioned in an interview as follows[4];

> *When in auditing, we approach auditee as watchdog, we are considered too focus seeking auditee's flaws. This supposition creates a negative impact, auditee tries hard to hide their problems, giving incomplete information and there is no cooperation at all from auditee.*

Other negative effect of the old paradigm implementation was stated by an interviewee as follows[5]:

> *When the internal auditor function is still as watchdog, there will be an audit recommendation at the end of the audit process. But, it is ignored by the auditee because auditee does not like the internal auditor's attitude.*

The participants also explained the solution for the condition described above as follows[6]:

> *Auditee hates internal auditing, though the company needs it. So, internal audit must use a different approach, no longer approaching as watchdog but as partner. What is a partner? We must assist auditee. If only auditing without consultation and catalyst, then how can we help auditee. Become a consultant as well as catalyst is the key to help auditee as early as possible, because preventing problems is much better. Personally, I agree to this principle. Actually, we adopt this idea of solution from the Institute of Internal Auditors.*

The adoption of new paradigm of internal auditing, initiated by the Institute of Internal Auditor (IIA), brought new images to internal auditors and positive impacts to auditee, as mentioned by the participant as follows[7]:

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[4] Interview with P, a junior-level auditor, at 25 September 2014
[5] Interview with N, a senior-level auditor, at 15 September 2014
[6] Interview with N, a senior-level auditor, at 15 September 2014

Using the new internal audit paradigm, change the auditee point of views toward the internal auditor. Internal auditor is no longer considered as a troublemaker who likes to find auditee's flaws. If they have problem, they now come first to the internal auditor to seek advice from the auditor. This is different than the past condition where they rather choose to hide their problems.

The interview also demonstrated the new role of internal auditor as a consultant and partner for the auditee, as stated below[8];

There is a shift in the role from watchdog to partner. Now, the internal auditor is not looking for any auditee's fault, but internal auditors also show the auditee that they have the chance to enhance and improve performance. Internal auditors explain to the auditee the risks so that we could prevent them making mistakes. Here, we play our role as partner.

The role of the head of internal audit unit is also important to the changes as indicated by the following statement[9]:

The application of the new internal audit paradigm started in 2009 initiated by the head of internal audit unit. By applying the new paradigm, the head of internal audit unit tried to make a change in the internal audit unit and in auditee too. From my personal point of view, the change is seen started in 2011.

The idea of the new paradigm was not fully supported by the staff of internal audit as indicated by the following comment[10]:

In controlling and giving assurance, internal auditors should also play the role of a watchdog. So, it is not possible if the internal auditor is not a watchdog. Internal auditor remains being a watchdog, but using different approach. For example, the internal auditor should also be a watchdog when investigating a fraud. In this case, it is not possible to use the new paradigm that is internal auditor is a partner. But, however, due to the current low rate of fraud, then the function of a watchdog is no longer dominant. So, the main function of internal auditor is currently a consultant and agent of change.

However, the internal auditors who are recently recruited have a different opinion of the new role. Typically, the new auditors are recruited from other units, and have

[7] Interview with J, a manager-level auditor, at 3 September 2014
[8] Interview with N, a senior-level auditor, at 15 September 2014
[9] Interview with N, a senior-level auditor, at 15 September 2014
[10] Interview with G, a senior-level auditor, at 15 September 2014

experience being audited in the watchdog mode. They have traumatic feelings about the internal auditor. They are pleased with the new paradigm, as mentioned below[11]:

> *In the early stage of my moving here, I did not like internal auditing. My dislike is caused by the general overview that internal auditor always seek other's flaws. But later, the chief of internal audit unit explained to us of the long-term plan and the high hope on the implementation of the new internal audit paradigm. Auditor in a company must cover three functions, consultant, catalyst and audit itself. So it is not only a matter of auditing but there are two additional functions. Besides, internal auditors also change its point of view as watchdog to become a partner of the unit being audited. This slowly changed me. Anyhow, the role of internal auditor was not straightforwardly change all auditor's point of view. There are still senior internal auditors who still apply the old internal audit paradigm until now. What makes me happy is that new internal auditors follow the new paradigm.*

Another participant described the internal audit functions under the new paradigm in detail as follows[12]:

> *Internal audit unit is one of the units that aims to assist management in controlling the company's business operations from A to Z. Business operation encompasses production, marketing, procurement, sales, maintenance and company's image. The internal audit function is controlling, in particular helping to control the activities of management in managing the company. This is the most important function. An auditor's function is how to be a good controls assessor, assurance provider and also a consultant. To materialize such target, we made a structure and decide who is the responsible person based on each respective field. Further we made several actions, such as making audit program and others to control transactions.*

Similarly, the auditee behaviour has also changed once they were confident that the internal audit purpose had changed. Now, participants say, auditees appreciate and accept the internal auditor as indicated by their cooperation in providing data for auditing. Also, the auditees are more active, and even come to see the internal auditor if they have a problem and to discuss a solution.

However, there are differences between the functions of audit, consulting and catalyst. For consulting and catalyst functions, the internal auditor may officially enter

[11] Interview with N, a senior-level auditor, at 15 September 2014
[12] Interview with E, a senior-level auditor, at 22 September 2014

the work place only if there is a request for assistance from the auditee. Thus, the internal auditor will help an auditee based on an assignment letter. In contrast, the internal auditor does not need a request from the auditee to conduct the audit function; the internal auditor needs the assignment letter to perform the audit activities. Yet, these three different functions of the internal audit may operate concurrently, as supported by the comment from interviewee[13]:

> *The functions of internal audit can be performed simultaneously. While an internal auditor is auditing, he or she can also act as consultant by giving audit recommendation.*

Another participant explained that consulting activity also can be conducted separately from an assurance work[14];

> *We have a routine agenda set out in the annual audit plan. The regular agenda includes assurance and consulting. When we worked on this assurance activity, usually there is only a small fraction consulting. Therefore, assurance and consultation can be done at the same time; or they could invite us in one meeting when they need inputs from an internal auditor.*

The audit, consulting and catalyst functions operate at different stages in a business process cycle, which consists of planning, process and product (result). The consulting function is performed in the beginning step of the business processes, when the auditee has to formulate plans. The catalyst is carried out in the middle stage, when the auditee conducts the working plan, while the audit function is conducted in the last phase of the business process, after auditees have carried out their work plan and delivered a result. Each of them will be discussed below.

The interviews indicated that the practice of internal audit started to follow the global development of internal auditing from 2009. The application of multiple functions of internal audit within this NS was very slow when you consider that the

[13] Interview with G, a senior-level auditor, at 15 September 2014
[14] Interview with E, a senior-level auditor, at 22 September 2014

initiation of this idea was in 1999 by the IIA. However, the head of internal audit was eager to adopt the IIA's thought on the multiple functions of internal audit, which created both positive and negative reactions from internal auditors and the auditee.

5.4.1. The Audit Function

The audit function remains a core function of the internal audit. One participant defined the function under the new paradigm as follows[15];

> *Audit is to provide assurance to the management that the company's business processes are carried out in accordance with the applicable rules. Risks involved in every business process, such as procurement, marketing, IT has also been mapped and its mitigation is also defined and required controls have been designed appropriately.*

During this time, this function has been changed primarily in four aspects: the scope of activities is getting more comprehensive, the audit approach has shifted from watchdog to consultant, the method of audit has changed to risk-based audit, and the requirement of competence of the internal auditor has changed. According to the interviewees, the scope of audit activities has altered and has become more complex[16]:

> *Yes the function of audit has changed. Presently, audit has a broader scope. This means that we could study the strategy, whether the design is already right or not, so is with its policy. Before, internal audit only compared the condition and criteria. Other than that, the old fashioned style of internal auditor tends to blame the auditee. Now, we prefer to work as a consultant. In that sense, how do we find solutions.*

In conducting the audit function, internal auditors perform a number of audit activities. In this matter, the internal auditors provide assurance after conducting the evaluation about whether the process is correct or has errors. In carrying out such assessments, the internal auditor compares the observation condition and the criteria. The gap between the real situation and the criteria will become the audit findings, and then the internal auditor has to find the cause of the problem and its effect. If the root of

[15] Interview with N, a senior-level auditor, at 15 September 2014
[16] Interview with D, a middle-level auditor, at 21 October 2014

the problem cannot be found, then such trouble cannot be solved and the issue will continue in the next period. This is called recurrent findings. Generally, there are two reasons for the emergence of such findings. Firstly, when the auditee did not follow up previous audit recommendations. Secondly, where the internal auditor cannot find the core of the problems. This auditor felt uneasy about such a situation:[17]:

> *Being an internal auditor I am puzzled. We are required to give the best. At the end of our audit, we are asked to provide recommendations, implications and total loss. But, that is just numbers. We cannot give a reward or punishment to the auditee. Also, if there is fraud, we cannot do anything. The findings of a fraud are not followed by any investigation audit or anything else. Sometimes, I find something that can be prevented, it should not happen but it continues to happen, especially when it comes to the top management. It is also difficult.*

The method in of performing audits has changed. Previously, the control-based approach was seen as best practice for internal control and as the guideline or criteria in the audit evaluation. The internal audit focuses on the function of the internal control. Under the new paradigm, the audit method is risk based which brings a new standpoint where the internal auditor concentrates on risks and controls management as well as ensures that the existing controls have been operating effectively. This new audit method brought consequences to the auditee, as mentioned by a participant below[18];

> *We have used the risk-based audit ever since four years ago. The consequence is, auditee must be able to identify and be responsible to all risks and controls the business processes in their working place.*

Moreover, the new audit method became a challenge for the internal auditors, in terms of their competence to understand business processes as a basis to provide recommendations to the auditee.

The audit function under the new paradigm uses new approaches. First, the auditors act as a consultant rather than as a watchdog in the audit process. Second, a risk-based audit is the new audit method. Finally, internal auditors are recruited from

[17] Interview with L, a middle-level auditor, at 20 October 2014
[18] Interview with J, a manager-level auditor, at 3 September 2014

other units to fulfil the competence requirement of understanding business operations. These changes are in line with the Internal Auditing Standards issued by the IIA.

5.4.2. The Consulting Function

Being a consultant is a new function of the internal auditor which has been brought about by the new paradigm as mentioned by an interviewee[19]:

> *With internal audit unit, the application of the new internal audit paradigm creates a change in the atmosphere, like the change in the auditors attitude in facing the auditee. But at this time, auditee has not yet feel these changes because we have not yet optimally performing the functions of consultation and catalyst. Because there are still senior auditors who still have the stand point of the old paradigm of internal audit. They believe that if we frequently have communication with the auditee, we will be no longer independent. They also believe that such interaction makes us feel attached to the auditee and will create conflicts of interest. This will create a sense of aversion to the auditee, but I do not agree with that argument.*

Actually, the consulting services have been provided by the internal auditor when the auditor applied the old paradigm of internal audit. Nevertheless, there are differences between consulting services in the old and new paradigms. In the old paradigm, the consulting service is given after the audit activity is completed. Moreover, consulting services concentrated on the suggestion to fix the error. In the new paradigm, the consulting services are provided primarily at the beginning stages of the business process when the auditee sets a working plan. Also, the auditee may have a consultation any time they need. Thus, the consulting service is not restricted to the end of the audit activity. Besides, the focus of consulting is the risks that may exist in the business process and how to eliminate or minimise the risk.

As consultants, internal auditors do not provide any assurance. A number of consulting activities provided by the auditor are contained in the Internal Audit Charter of 2012. Firstly, preparing and carrying out the control self-assessment (CSA) in the

[19] Interview with N, a senior-level auditor, at 15 September 2014

main business processes. Secondly, giving suggestions and objective information concerning the activities is examined at all management levels. Thirdly, internal consultation services may be offered to management if necessary to discuss preparation of a working plan, the company budget, risks and control identification or business strategy. This situation is confirmed through the following comment found in an interview[20]:

> *Changes in government regulations in terms of mining, prices and transportation associated with business enterprise processes, require companies in particular the working units (auditee) to follow these changes. Provide assistance to the auditee in terms of providing an understanding on the changes in the regulation puts our role as a consultant.*

In performing the role of consultant, there are a number of approaches used by internal auditors toward the auditee. One of participants mentioned it below[21]:

> *Serves as a consultant, we usually are invited by the auditee in drafting the procedure. In these conditions, we will inform the auditee that they need to consider several aspects, such as the law and regulations and internal control.*

Other participant employed another style of approach as follow[22]:

> *Almost every day or at least once in a week I sit and talk with the IT Unit employees. I ask them what are the problems that they have. Later, they told me about their problems. I listen to their complains because their information is an input for me. I make a note of it not as a findings but to seek solution on their problems. We are really focus in finding solution for their problems, this they know. Every day, if they find problem, we suggest a solution to auditee. But, we do not give suggestion that is implemented directly. On the other hand, we only provide them with a guideline to the auditee, and the auditee should think about the implementation details.*

From that comment, it could be said that the internal auditors are invited by a department that wants to make a working plan. In that case an internal auditor's attendance at the event is as a consultant who then provides consulting services to the staff of the department. In this case, the consulting services only provide advice to the

[20] Interview with E, a senior-level auditor, at at 22 September 2014
[21] Interview with D, a middle-level auditor, at 21 October 2014
[22] Interview with N, a senior-level auditor, at 15 September 2014

auditee to consider the risks of business processes that are being planned, determine controls that need to be applied in order to anticipate and mitigate risks. Internal auditors ask the auditee to include all recommended components in their working plan. In other words, as a consulting function, the internal auditor will merely explain the criteria including factors that should be considered and performed. However, the auditee is responsible for identifying risks and their controls and ranking the risks by number.

In addition, internal auditors may give opinions on whether or not the internal control is appropriate based on two main points. Firstly, the internal control should be good enough to cover an activity. Secondly, it should not lead to the bureaucratic procedures taking longer. However, internal auditors are not involved in designing the internal control.

Not only the auditees take benefit from the consulting function of internal audit, but also management, as mentioned by a participant below[23]:

> *One of the reasons why this internal audit unit is formed is to help the top management making strategic decisions. Such as, the decision of the top management to build a new factory based only on the feasibility study report which has been assessed by the internal auditor. The Internal auditor's opinion will influence the decision of top management.*

The consulting function under the new paradigm of internal audit is performed along with the stages of business process. The alteration is in conformity with the Internal Auditing Standards of the IIA.

5.4.3. The Catalyst Function

The other new internal audit function is as a catalyst. The internal auditor performs the catalyst function if requested by the auditee. In this case, the auditee carries out the activities of the working plan which is the second stage of business activity. In this stage, the auditee has defined the risk, has implemented the internal

[23] Interview with R, a middle-level auditor, at 22 October 2014

controls and set the risks' mitigation. As a catalyst function, the internal auditor assists the auditee to evaluate itself whether the risk has been well controlled by applying internal control and risk mitigation. The way of an auditee assesses itself is called Control Self-Assessment (CSA). The interviewee explained the aim of undertaking the CSA by the auditee as follows[24]:

> *Self-Assessment Control (CSA) is aimed to strengthen the internal control. Auditee was forced to apply the CSA because each working unit is expected to monitor the risks inherent in the business processes and determine the proper internal controls. Therefore, overall internal control will be better. We took this concept of risk management. In addition, we use a CSA survey results as a basis to conduct a field audit.*

Whilst the aim of the evaluation of CSA by auditors was described by participant as follows[25]:

> *We act as facilitator in Control Self-Assessment Theory. In the new internal audit paradigm, a facilitator does not seek the auditee's flaws. But facilitator is more focus in looking for the working unit's shortcomings, so that they are more open in telling their problems. Different than the previous old paradigm internal audit, we come up with the attitude of doing the audit; now by applying the new paradigm of internal audit, we come to evaluate the character and thus be in the form of discussion.*

The auditors assessed the CSA implementation by giving the questionnaires to auditees. One participant clarified what the auditors did with the responses to the CSA's questionnaires as follows[26]:

> *Assessment on the implementation of the CSA by the auditee covers several aspects. First, the auditors evaluate the details of business processes of the working units made by the auditee. Second, the auditors examine the risks arising in the business processes that are identified by the auditee. Auditors review the controls made by the auditee to minimise risks. In internal audit, auditors remind the auditee by giving recommendations to auditee if there are still unidentified risks and controls are not done. Other than that we also deliver it to GRC unit.*

The catalyst function under the new paradigm of internal audit is conducted by influencing the auditee to make an alteration. An example of this function is when

[24] Interview with P, a junior-level auditor, at 25 September 2014
[25] Interview with D, a middle-level auditor, at 21 October 2014
[26] Interview with D, a middle-level auditor, at 21 October 2014

auditors assist the auditee in carrying out CSA. The implementation of the function is in line with the risk management concept.

In order to perform professionally the three functions of internal audit, there needs to be three supportive aspects. Those are position, people and process. These aspects are presented below.

5.5. Position of Internal Audit

Position consists of six elements, such as the Internal Audit Charter, independence, the scope of activities, alignment purposes between internal audit and PT. NS, organisation and reporting as well as policy and procedures. Each of them will be presented in the next subsection as follows:

5.5.1. The Internal Audit Charter

PT. NS' Internal Audit Charter (2012) prescribes that it is important to officially authorise the internal auditors to perform their functions in a professional manner, so they can be accepted as well as supported by other units. The Charter is an official guideline for internal auditors to generate work that meets certain quality standards and supports the activities of the company. One interviewee described the way the Charter has to be approved[27]:

> *We propose an Internal Audit Charter to the president director and Audit Committee. The Charter is signed by both parties.*

A participant explained which parties were responsible for composing the Charter as follows[28]:

> *The preparation of the Internal Audit Charter will be done by involving several parties, the Chief of the Planning and Development of Internal Audit Bureau, Chief of the Accounting and Finance Audit Bureau, Chief of the Commercial Audit Bureau, Chief of the Information and Communication Technology (ICT) Audit Bureau, Chief of the Engineering Audit Bureau, Chief of the Internal Audit Unit and Audit Committee.*

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[27] Interview with J, a manager-level auditor , at 3 September 2014
[28] Interview with E, a senior-level auditor, at 22 September 2014

An interviewee mentioned the Charter's content as follows[29]:

> *An Internal Audit Charter basically contains the authority of the auditor to audit all business units, and the auditor is responsible to the Board of Directors and Audit Committee. Also, the position of the internal audit unit was under the president director. Only these three things that I remember.*

The NS Internal Audit Charter (2012) consists of four parts. The first part covers the background, goal, vision and mission. The second part comprises the definition and purpose of internal audit, the scope of assignments of internal audit, the authority of the internal auditor, the status of internal audit, the organisational structure of the internal audit unit, communication and responsibilities of internal audit. The third section contains performance standards. The standards encompass professionalism, independence and objectivity, competence, the internal **c**ontrol, management of internal audit, execution of activities as well as follow-up monitoring. The fourth part is an ethics code that includes standards of conduct.

The definition of internal auditing which is written in the Charter is taken from the Professional Standards of Internal Audit (SPAI) in Indonesia. The definition contained in SPAI is adopted from the International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA). The definition is as follows[30]:

> [a]n internal auditing is an independent assurance and consulting activity and is objective in nature, designed to add value and improve an organisation's operations. Internal audit activity helps an organisation accomplish its objectives by conducting a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

In addition, the Charter also includes the purpose of internal audit in NS and helps management and other units to achieve their goals and objectives. Therefore, the internal audit provides assistance in the form of analysis, assessment, recommendation, consultation and follow-up monitoring of other units' activities.

[29] Interview with K, a middle-level auditor, at 25 September 2014
[30] The Internal Audit Charter, 2012, p.3

The Internal Audit Charter 2012 also states that the internal auditors coordinate with working partners, the audit committee and external auditors when conducting internal audit duties. The coordination aims to obtain an appropriate scope of audit and reduces duplication of activities and is conducted by having meetings with these parties. Periodic meetings with the audit committee are held every once every three months to discuss important issues in internal audit activities. Meetings of internal auditors with the audit committee, external auditors, accounting and finance department cover discussion of the audit plan, finding solutions for problems found in the audit activities, sharing the audit procedure and working papers, and distributing the audit reports among the internal and external auditors.

However, a participant gave a contrasting comment about the Charter regarding sharing the audit report as follows[31]:

> *Our relationship with an external auditor is as partners. In terms of internal audit reports, we will give the report to the external auditor if the head of internal audit unit give us permission to do so. In fact, for strict confidential documents the external auditor must first have an approval from the CEO. But, so far, it is prohibited to provide internal audit reports to an external auditor since it is very confidential. The internal audit report is strictly for the organisation's internal interest. The external auditor has never asked us to provide such report. They only ask for data. This provision is applied to all external auditors, the public accounting firms, BPK and BPKP.*

Another argument is given by an interviewee below[32];

> *This company is not only listed at the Indonesian Stock Exchange, but it is also a public company. A public company in terms of giving information is a company opened for stakeholders. But as a company, we must select the information that is going to be publicly consumed. If we meet the demand of the related BPK by providing access to a very detailed data, we also had to so to such similar requests from other parties, such as minority shareholders. And this is very risky for the company because the minority shareholders are actually be the company's competitor.*

[31] Interview with R, a middle-level auditor, at 22 October 2014
[32] Interview with N, a senior-level auditor, at 15 September 2014

In NS, the internal auditors have unrestricted access authority in performing their duties and this is included in the Internal Audit Charter 2012. This access covers [33]:

> [a]ll information at all levels of management and employees; every decision that is generated by all levels of management; all rules that apply within the company; all information, data, and relevant documents required; every place and activities should be examined.
>
> [t]he internal auditor's authority includes also by asking independent experts to assist the internal auditor; holding and incidental regular meetings with top management, Board of Directors and or Audit Committee.
>
> [f]or special cases, such as if the internal auditor found an indication of fraud during audit, this said fraud will be discussed with the Managing Director or the Audit Committee to be followed up.
>
> [f]or internal operation under the Board of Directors will be investigated by the internal auditor who is assisted by an external auditor, while for the level of or above the Board of Directors and will be examined by an external auditor.

Accordingly, one of the participants described the authority of internal auditors as follows:[34]

> *The authority of internal auditor covers an unlimited access as described in the Internal Audit Charter. Other than that, also an authority in providing audit recommendation, where such recommendation must be followed up by auditee.*

Besides, the Internal Audit Charter 2012 states that the responsibility of internal auditors is to provide analyses, assessments, recommendations and consultations and to submit a report on all activities undertaken in accordance with Professional Standards of Internal Audit, International Standards for the Professional Practice Framework (IPPF), Standards and other professional behaviour demanded by the code of ethics, other rules that bind the company such as the management system (SMSG), decisions of the board of directors, manuals and Standards Operating Procedures (SOP), as well as laws, regulations and legislation in force.

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[33] Internal Audit Charter 2012, p. 5-6

[34] Interview with L, a middle-level auditor, at 20 October 2014

Accordingly, the internal audit responsibilities are in line with the objectives of internal audit as mentioned by an interviewee as follows[35]:

> *An internal auditor's responsibility is to make sure that the main internal controls have been implemented properly. An internal auditor is responsible for reviewing all the controls associated with business processes carried out by all units in the company. Auditors then make reports on the results of the revision of the internal controls to the President Director. Evaluate whether the working unit SOP is adequate or not. In this case, we serve as a consultant. However, basically the most important task of an internal audit is to conduct audit in order to make sure that everything runs well.*

It is written in the charter that internal audit charter can be updated every year. However, the charter document indicated that it was last updated in 2012. In 2014, the charter had not yet been revised since it was considered that there had been no significant changes that called for adjustments. The Internal Audit Charter 2012 is an improvement on the Internal Audit Charter of 2010. The Charter of 2010 must be adapted as an organisation changes, and business processes and governance of the internal audit unit are adjusted The amendments in the Internal Audit Charter 2012 encompass the name of departments, a modification in accordance with the regulation of Capital Market (Bapepam-LK/OJK) and investigation authorities in the case of fraud. The adaptations to the Bapepam-LK/OJK regulation encompass a number of points; the effectiveness of an implementation of risks mitigation and internal control, the application of Control Self-Assessment (CSA), providing a consultation service to management, which includes formulating the working plan and budgeting of the company, identifying risks and controls, developing the business strategy of the company, and the prohibition of having double position as the internal auditor and operational staff concurrently.

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[35] Interview with J, a manager-level auditor, at 3 September 2014

The Charter used to be reviewed periodically to accommodate the need of change. However, the current charter has not been changed for a while as mentioned in an interview as follows[36]:

> *It has been running for two years but still no change in the internal audit charter, because we feel there is no need for it. Typically, after two years we will develop the internal audit charter. One of the things that we need to develop in the internal audit charter is to establish internal audit unit in the subsidiary in Hanoi, Vietnam, but there is still no permit to do it.*

Another participant explained the changes made from the prior charter[37]:

> *Although it is not too principle there is still a little bit of change in the internal audit charter. For example, the insertion of the change from using the old method of auditing to the new audit method, i.e risk-based audit.*

A Code of Conduct for internal auditors is also contained in the Internal Audit Charter 2012. This Code of Conduct sets out basic principles of behaviour, and in practice requires careful consideration of every internal auditor. Violations of the code of conduct may result in questioning and being given a warning, being dismissed from auditing duty or from the company. The Code of Conduct must be obeyed by the internal auditors in NS and consists of:

- To behave and be honest, objective and careful in carrying out the task.
- To have high integrity and loyalty to the profession, company and internal audit unit.
- To avoid activities or actions that harm or it is suspected may harm the internal audit profession or company.
- To avoid activities that conflict with the interests of the company or that resulting in cannot do duty objectively.
- To work based on expertise, knowledge and experience, as well as the existing professional standards and legislation in force and continue to develop expertise, effectiveness and quality of work.

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[36] Interview with J, a manager-level auditor, at 3 September 2014
[37] Interview with E, a senior-level auditor, at 22 September 2014

- Do not accept gifts of any kind and from anyone, either directly or indirectly, including from the auditee, clients, customers, suppliers, and partners and or stakeholders that interfere with or it is suspected may interfere with the professional judgment of auditors.
- To maintain morale and dignity as the internal auditor.
- To keep the confidential information of the company which are entrusted to him / her and do not use information obtained for the personal benefit.
- To report all audit results by revealing the truth, as existing facts and by not hiding things that could damage the company funds or violate the law.

It is written in the Charter that the formation of the Charter refers to two regulations: one that the Ministry of SOE issued in 2002 concerning good corporate governance implementation, and the Bapepam-LK/OJK regulation published in 2008 regarding the Internal Audit Charter Guideline. The Charter also used the Profession Standards of Internal Audit as the guideline in composing the Charter.

In terms of the Internal Audit Charter, the internal audit unit has been following the Standards issued by the IIA in all aspects, such as the existence of a formal written Charter, the content of the Charter, the parties who approve the Charter and the requirement of periodic assessment.

5.5.2. The Independence of Internal Audit

As stated in the Charter the activities of internal audit must be independent and the internal auditors must be objective in conducting their functions. Since the adoption of the new paradigm, the internal auditor has multiple functions, namely audit, consulting and catalyst. Providing these functions are challenges for internal auditors, particularly in terms of maintaining the independence as a unit organisation and objectivity of internal auditor.

5.5.2.1. The Organisational Independence

In order to ensure the independence of the internal audit unit, NS places rules and regulations in the Internal Audit Charter 2012. The position of the internal audit unit within the organisational structure of the company is at a certain level that ensures the internal audit unit is free from interference and able to implement its authority. Therefore, the internal audit unit is under and directly responsible to the president director of the company. Moreover, the head of internal audit unit is appointed and dismissed by the president director with the approval of the board of directors. On this matter, an interviewee explained as follows[38]:

> *Candidate for the head of the internal audit is appointed by a president director who then proposed it to the audit committee for their approval. And if the audit committee reject such nomination, then the CEO will appoint someone else for the position of head of internal audit unit and do the same procedure again. The appointed head of internal audit then approved by the audit committee is reported to Bapepam-LK/OJK.*

Additionally, as described in the Charter, the head of the internal audit unit should periodically deliver the report of internal audit activities to the president director as well as to the audit committee of the board of directors. The following finding from an interview also indicates a similar situation[39]:

> *The ICoFR result of review and Analytical Review are delivered to the President Director, audit committee, financial director and the related units.*

Besides the reporting line, the existence of interference from the CEO in audit activities may impair the independence of internal audit. Comments on the independence of internal audit unit were found to vary. The independence of audit unit was indicated by the following comments[40]:

[38] Interview with B, a senior-level auditor, at 15 September 2014
[39] Interview with D, a middle-level auditor, at 21 October 2014
[40] Interview with D, a middle-level auditor, at 21 October 2014

> *The president director never interferes in making the audit plan. Normally, we propose the internal audit plan through a mechanism of discussion. If there is a revision, then the president director will review it. But, so far, a president director never deletes anything that we want to audit. He gave us freedom.*

However, another auditor's comments are contrary to this view of the independence of the internal audit unit:[41]:

> *The president director always interfere during the internal audit, but still in a positive way. Like giving us some questions, for example, why the examination is not deep enough, and why an audit on control is inadequate. Usually these questions arise if there are new cases and existing controls are not strong enough.*

Another comment which seems to suggest dissatisfaction with top management was made by an interviewee[42]:

> *So far, I think the president director is not completely supporting the internal audit. Forms of support are limited to the establishment of an internal audit unit. However, the president director has not given support to the evaluation or analysis of the findings of the audit report.*

The support of top management is reflected in approval of the Internal Audit Charter 2012 by the president director and independent board of director who also acts as the head of the audit committee. Similarly, an endorsement of the Internal Audit Plan (RKIA) 2014 is conducted by the president director and the head of audit committee. Additionally, another form of top management support is the meetings between top management and the internal auditors at least once a month to discuss issues that are considered important or need to be followed up, or need to be raised at the board of directors' meeting.

In the Internal Audit Charter 2012, it is stated that the internal auditors should build coordination and work together with the audit committee. A cooperation practice between auditors and the audit committee is described by an interviewee below[43]:

[41] Interview with E, a senior-level auditor, at 22 September 2014
[42] Interview with E, a senior-level auditor, at 22 September 2014
[43] Interview with D, a middle-level auditor, at 21 October 2014

Audit Committee responds the internal audit report. When there is serious case, we are asked to meet.

The Charter also states that the internal auditors should hold periodic meetings with the audit committee, either with or without the presence of directors at least once every three months to discuss problems, issues and important developments surrounding the internal audit activity. In this case, the interviewees gave detailed explanations about the meetings with the audit committee as follow[44]:

We have a routine meeting with the audit committee every three months. Meaning the meetings are held four times in one year.

In terms of independency of the internal auditor in undertaking audit activities, an interview demonstrated the management support to the auditors as follow[45]:

There is no limitation from the president director in performing audit.

However, other participant provided a contrasting comment on the independence of an internal auditor as below[46]:

No interference from the president director in the internal audit independency. However, independence is still a big question. Please judge it yourself.

An auditor described responses of the auditee and the top management toward the audit reports as follows[47]:

As for me, an audit recommendation is the largest contribution of the internal auditor for the company because recommendation will be followed up by the auditee and also read by the president director. Sometimes there an internal audit report was directly put into the drawer by the president director. This is indicated by the absence of a response from the president director and suddenly we received another assignment. Usually a president director will respond the internal audit report in a period of two weeks, followed by replying the report together with us, asking our recommendation. I do not know how many internal audit reports are ignored by the president director, but obviously, it happened. Usually the president director will ignore any report concerning himself. I was annoyed because I worked hard but there was no response to the audit report I made. What a waste!

[44] Interview with I, a middle-level auditor, at 21 October 2014
[45] Interview with D, a middle-level auditor, at 21 October 2014
[46] Interview with E, a senior-level auditor, at 22 September 2014
[47] Interview with A, a middle-level auditor, at 12 November 2014

The position of internal audit unit under the CEO in the organisation has a negative impact on the independence of the internal audit which is reflected in the interview below[48]:

> *We are the President Director subordinate, so we cannot force him. If a president director would not accept the findings of an audit reported to him and ordered us to throw some of audit findings, we will do like he said. This is an instruction. It is the risk of being under the president director. Our position is the same as the president and his ministers. But, for the sake of professionalism of internal auditors, all audit records will not be discarded. On the other hand we will keep the working sheet of our audit safely. The Board of Directors will not get a complete set of audit report because we have discarded some of our audit finds as instructed by the president director. This is the principle we got at our course sessions. The instruction of the president director was obeyed, but not in my field.*

In terms of organisational independence, the internal audit unit has partly followed the Internal Audit Standards issued by the IIA. As although the internal audit unit delivered the audit reports to the CEO and the audit committee, there was interference by senior management over the audit reporting. This condition demonstrates that the CEO does not yet fully support the internal audit activity as required by the Standards.

5.5.2.2. The Individual Non Subjective (Objective)

In addition, personal independence as the internal auditor has also attracted the attention in NS. It is reflected by the expression of concern about the independence of the internal auditor as an individual in the Internal Audit Charter 2012. Moreover, it is also stated that the rules of such independence refers to Bapepam-LK/OJK regulation published in 2008.

The Charter 2012 states that internal auditors should be independent and objective when they perform their audit activities. They must be independent as a personal, so that they can give an important opinion which is impartial and not prejudiced in the

[48] Interview with N, a senior-level auditor, at 15 September 2014

implementation and reporting of the audit. Moreover, an internal auditor's objective is an independent mental attitude when conducting audit activities. The objectivity of internal auditor cannot be defeated by other considerations.

The multiple functions of the internal auditor, as the assurance provider as well as the consultant and the catalyst do not place the auditors in a difficult situation in terms of maintaining their personal independence toward the auditee. This is reflected in an interview as follows[49].

> *I have no problems maintaining my independency to the auditee. I only give advices and auditee runs the operation. We give advices on several aspects for their consideration in decision-making. When viewed from the organisational structure, we indeed are under the control of the CEO. In view of this position, however, independence is a dilemma, because we are working for the company as well.*

Additionally, the Charter 2012 also states that to be objective, requires that internal auditors be honest to themselves and confident that their works are of high quality, reliable, trustworthy and free from influence and pressure from outside parties. Even though in the previous section, it was demonstrated that the internal auditors are not free from pressure of top management. The auditors seem to be trying to be objective by saying[50]:

> *We maintain our independence usually by establishing a relationship with the working units, but remain independent. This means that we follow the rules when we do the audit. In addition, as a consultant, the internal auditor will invite other units, such as the legal and accounting department, and we will provide advice on the aspects of controlling. However, we are only limited to providing advice, but the decision remains in the hands of top management.*

The Charter 2012 explains that in order to maintain the independence and objectivity as specified in the Professional Standards, an internal auditor should avoid a situation of conflict of interest. An auditor recruited internally is prohibited to audit his / her former unit within a one year period. Similarly, internal auditors are not allowed to

[49] Interview with E, a senior-level auditor, at 22 September 2014
[50] Interview with D, a middle-level auditor, at 21 October 2014

have dual duties as the internal auditor involved concurrently in operational units in both the public company and its subsidiaries. However, in practice, many of these rules were violated as indicated from the following interview[51]:

> *The internal auditor should not be involved in CSR activities. However, some internal auditor engaged in sport activities as treasurer. And the head of internal audit unit is rather loose. In such cases, the head of internal audit unit only provides advice and does not require the auditor to be involved in CSR activities. The negative impact of this dual role, as an administrator and internal auditors, they will make the report look good; not neutral because they audit a report they made themselves.*

The violation was also done by a high rank official in the audit unit as mentioned below[52]:

> *A high rank official in the internal audit unit should also be independent. Cannot have a dual position. However, this high official of the internal audit unit is also the board of directors of the VU, a subsidiary company. However, NS has only a small portion of shares in this subsidiary company.*

The auditors' position above which may create a situation of conflict of interest also had been reported in the QAR report 2011. It was stated in the report that such positions potentially impaired the objectivity of internal auditors both in fact and in appearance. Therefore, the independent assessor of the QAR recommended the audit unit follow the Standards.

In terms of individual objectivity, the internal auditors seem to have not yet fully followed the Standards, particularly since they also have placed some auditors within operational activity. According to Standards, this condition should be avoided since it could impair the objectivity of internal auditors.

[51] Interview with K, a middle-level auditor, at 25 September 2014
[52] Interview with K, a middle-level auditor, at 25 September 2014

5.5.3. The Scope of Activities of Internal Audit

The new functions of audit, consultant and catalyst, alter the range of assignments of the internal auditor and cause them to become more complex. These scopes of work consist of all the existing business ranges in the holding company and the subsidiary. The activities contained in the Internal Audit Charter of 2012 comprise evaluating, testing and assessing the effectiveness of control, risk management and governance processes. Regarding the audit tasks practiced by an auditor, it was mentioned that[53]:

> *Up till now, at least I only give recommendations on risks and the applied control. Other than that, there are other things that need adjustment. As example, several procedures are ignored by the auditee, and we need to remind him/her. There are activities that have no Standard Operational Procedures (SOP), that we suggest to make later.*

The evaluation and enhancement of effectiveness of risk management, controlling and governance process are accomplished through conducting activities of assurance, consulting and catalyst. In terms of assurance, it is attained by audit activities. In an interview, it was mentioned[54];

> *There are two kinds of audits, operational audits and special audits. Operational audit is a routine audit. Every year, we arrange the schedule, time, theme of audit, the number of internal audit staff, and the cost to conduct the audit and non-audit. Operational audit consists of accounting audit and financial, commercial, engineering and projects, as well as IT. Special audit was not routine because it depends on the demand of the chief executive.*

In terms of the scope of internal audit activity, the internal auditors have provided assurance and consulting services related to the organisation's governance, risk management and control processes. This scope of work is in line with the standard's recommendation.

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[53] Interview with E, a senior-level auditor, at 22 September 2014

[54] Interview with F, a senior-level auditor, at 25 September 2014

5.5.3.1. Operational Audit

The operational audit is regulated by the Standard Operating Procedures (SOP) for Audit of Operational and Management System 2011. This document was developed to advocate the requirement various rules and regulations such as the Decree of Ministry of SOE, Decree of the Board of Directors and Internal Audit Charter 2012.

The SOP for Audit of Operational and Management System 2011 regulates operational audits as follows[55]:

> [a]uditing all processing activities at all level of production, marketing, accounting and finance, general, human resources, supply of goods and services and the implementation of project.
>
> [m]ake sure that the company's operation is done effectively and efficiently as required and always be improved to enhance the company's performance.
>
> [e]nsures that any discrepancies or irregularities found in the audit will be followed up in accordance with the schedule and commitments that have been determined so that it will not be repeated.
>
> [m]ake sure that the applicable rules and policies are in accordance with the operational standards usually applied in accordance with the principles of good corporate governance, legislation and general provisions.

In terms of compliance to government legislation, the interviewee below revealed that[56]:

> *From my point of view, the contribution of internal auditing in helping SOEs in general and the working units in particular to observe the legislation is not optimal, as there are some regulations that are not 100% implemented. For example, the laws of human resource development which stipulates that trade unions in the company should not be intimidated by the management, but apparently that is not the case.*

The operational audit involves four central points as in engineering, commercial, accounting and financial, and IT audits which are performed by four audit bureaus each with its own specialty. The internal document, the Internal Audit Plan 2014, defines these specific audit activities.

[55] SOP for Audit of Operational and Management System, 2011, p.3
[56] Interview with A, a middle-level auditor, at 12 November 2014

5.5.3.1.1. Engineering Audit

The Internal Audit Plan (RKIA) of 2014 states that an engineering audit includes the assessment of risk, control and efficiency in the business process of production, which embraces the performance of production, utilisation of energy, raw materials, auxiliary materials, substitution materials, operating supplies (such as grinding balls, refractory stone, lubricating oil, etc.) and spare parts to ensure the achievement of Key Performance Indicators (KPI) in the production unit. According to one participant, the scope of engineering audit in practice consists of[57]:

> *Engineering Audit includes the company operational audit, which covers the production processes and its quality, and maintenance. We also audit Project.*

In conducting the engineering audit, the internal auditors will consider the level of risks contained in the list of risks, as explained in the interview below[58]:

> *Engineering Audit is done based on audit topics determined by the level of risks listed in the risks list. High risks would be a top priority for auditing. Therefore, the audit topics vary each year in line with the change of the level of risks. However, the risks will not change as long as there is no change in business processes. Nevertheless, the risks level may be changed due to the condition of the cement plant.*

In the RKIA 2014, it was shown that the Engineering Department had 17 risks, 56 internal controls and 31 risk mitigations.

In terms of the audit timing, the engineering audit needs longer time than others as mentioned by the participant below[59].

> *We need three months to complete an audit.*

[57] Interview with Q, a middle-level auditor, at 24 September 2014.
[58] Interview with E, a senior-level auditor, at 22 September 2014
[59] Interview with E, a senior-level auditor, at 22 September 2014

5.5.3.1.2. Commercial Audit

The Internal Audit Plan (RKIA) of 2014 states that the activity of commercial audits includes a review of the effectiveness of risk mitigation implementation and internal control across the entire transaction process in the procurement business process, marketing, distribution and transportation. The procurement business process comprises the activities of work units demands, inventory, purchasing and warehousing. Moreover, the scope of the marketing business process consists of ordering, allotment, selling, distribution, and sales receivable.

The information contained in the RKIA is supported by one interviewee who explains the activity of commercial audit as follows[60]:

> *Commercial audit evaluates the business processes of human resources, marketing and supply and special audit by special assignment letter.*

The interviewee explains the scope of commercial audit in detail as follows[61]:

> *For marketing audit, we will check the sale policy, marketing area, and debt for delivery costs. While for supply audit, we check the procedure to buy material, spare parts and service. We know how auditee gets goods or services, do they work according to the existing standard operational process or not.*

The guidance for conducting the commercial audit is explained through the interview, as follows[62]:

> *For guideline audit, we look at the job description, their standard operating procedures, and also the relevant regulations, such as the Decree of the Minister of SOEs. We check whether the procedures have been updated or not.*

In carrying out the commercial audit, the internal auditors use risk-based audit method as explained by the participant below[63].

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[60] Interview with R, a middle-level auditor, at 22 October 2014
[61] Interview with F, a senior-level auditor, at 15 September 2014
[62] Interview with F, a senior-level auditor, at 15 September 2014
[63] Interview with R, a middle-level auditor, at 22 October 2014

The marketing process has many risks. For example, we send a cement bag at a particular kilometre distance. An activity like this has many risks, such as the outdoor humid temperatures can have an impact on the formation of clumps of cement. This risk must be anticipated by covering the cement with a waterproof tarpaulin.

The interview indicates that the risks within the marketing process are shared with other parties who are involved in the processes, as mentioned below[64].

Therefore, risks must be described in detail to minimise the risks. It is one of the methods of risk management. Another technique is to divide the risk between cement manufacturers, shipping agents, and distributors. For example, we send cement to the distributors by using a shipping agent. If some cement were damaged on the way to a distributor, then the damaged cement is the responsibility of the shipping agent. However, if the cement was damaged while still kept in the distributor's store house caused by careless handling by their workers, then the distributor must be responsible for it. Similarly, if the cement was already defected while still in the factory, this will be the responsibility of the company.

All the risks from a number of departments that are included in the commercial process are contained in the RKIA 2014, in which there were 47 risks in total. To overcome the risks, the departments in the commercial process set 116 internal controls and 100 risk mitigations.

Contrary to the broad scope of commercial audit, the commercial audit bureau has few internal auditors, as stated by the participants[65].

I only have two staff of internal auditors, I should have 5-6 auditors for my team to do commercial audit. I could ask for internal auditors help from other audit bureaus, because we use matrix system in internal audit unit. Usually it took two months to complete the commercial audit.

5.5.3.1.3. Accounting and Finance Audit

The scope of an accounting and finance audit comprises all actions or processes that impact on the financial report, such as activities of marketing, human resources, and procurement. The audit consists of number of processes that create costs and generate incomes that have to be recorded as mentioned by the participant below[66].

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[64] Interview with R, a middle-level auditor, at 22 October 2014
[65] Interview with F, a senior-level auditor, at 15 September 2014
[66] Interview with G, a senior-level auditor, at 15 September 2014

We check the transactions to make sure that the transactions were presented correctly in the financial report. Reviewing is done using several ICoFR controls, Internal Control over the Financial Reporting. We evaluate whether such controls have been performed or not. This review is likely to be an assurance service.

Basically, this activity focuses on the periodic review of the financial statements (analytical review) and tests the implementation of Internal Control over Financial Reporting (ICoFR), including an audit of the Partnership Program and Community Development Program as mentioned by an interviewee[67];

We do analytical review and review on ICoFR. Analytical review is done on interim financial statements and annual financial statements. The interim financial report is published every three months.

5.5.3.1.3.1. Analytical Review

The Standard Operating Procedures (SOP) of Analytical Review for Financial Statements 2010 is a guideline for internal auditors in PT. NS for conducting a review over the financial statements. The document states that the procedures of analytical review are prepared in line with the International Professional Practice Framework (IPPF) - Practice Advisory 2320-1: analytical procedures, professional standards of public accountants, Auditing Standards (SA) sections 722 and the Internal Audit Charter 2012. The instruction is made with the assistance of an accounting firm and also using a public SOE listed in NYSE as a benchmark as indicated by the following comment[68].

References used when devising Analytical Review guidelines consisted of two types, namely comparative study at PT Telkom in Bandung and consultation with the public accounting firm EY. So, we saw how Telkom has performed an analytical review which we imitated later. And EY Public Accountant Firm gave solutions or the step by step way to carry out the analytical review.

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[67] Interview with J, a manager-level auditor, at 3 September 2014
[68] Interview with K, a middle-level auditor, at 25 September 2014

The review is the implementation of inquiries and analytical procedures. This activity aims to provide a limited assurance that there are no material modifications that need to made to the financial statements to present the report in accordance with generally accepted accounting principles in Indonesia. The term 'materiality' is used to express something that is considered to be reasonably known by users of financial statements. Information is considered material if the omission or errors in the information recording (misstatement) influence the decisions that should be taken. The scope of such review covers arrangements regarding the procedures in the implementation of the review and reporting of the review’s results of the financial statements. The financial statements consist of a balance sheet, income statement, and statement of changes in equity, a cash flow statement, as well as notes of the financial statements.

The participants stated that in PT. NS, normally the analytical review of the financial report is conducted before the report is published. This review verifies the figures in the financial statements. Such review is performed every three months with the time needed to complete it is clarified by a participant below[69];

> *Usually we need 1 (one) month to finish the Analytical Review. And we do this review once in three months. Thus, Analytical Review is done four times in one year.*

In conducting the financial audit activity, the internal auditors focused on specific accounts as explained by an interviewee as follows[70];

> *We need only one week to complete a financial audit. This is because we are only focus on significant accounts. So, we define what critical accounts should be examined every year. And the important accounts must be reviewed every three months.*

The participant described which procedures are carried out with the audit reporting as mentioned below[71];

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[69] Interview with J, a manager-level auditor, at 3 September 2014
[70] Interview with J, a manager-level auditor, at 3 September 2014

If there is a suggestion to do some revisions on the Analytical Review report from the audit committee, we would do it, but in the next quarterly period report. We will inform the matter to the accounting and finance department to be checked again. Typically, the correction related to Accounting Standards. After the report was revised, we report it to the audit committee.

The internal auditor determines which important accounts each year need to be checked including the accounts that are required to be assessed every three months. Thus, the internal auditor only examines the significant accounts which focus on the understated or overstated accounts.

5.5.3.1.3.2. Internal Control over Financial Reporting Review

An Internal Control over Financial Reporting (ICoFR) activity is to provide a reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements to external parties, in accordance with generally accepted accounting principles (GAAP). ICoFR is an internal control system referring to the international standards of internal control (COSO Internal Control Framework).

The ICoFR is guided by the Standard Operating Procedures (SOP) for Testing and Evaluate the Activity Level Controls over Financial Reporting 2010. The activity level controls are the controls performed at each process of organisational activity, such as authorisation, verification, reconciliation and other activities in order to prevent the occurrence of an error / fraud and to safeguard assets. The test procedures for such ICoFR are based on the Sarbanes Oxley section 404 and Auditing Standards (AS) No 5. The scope of such procedures includes arrangements regarding the procedures to test the activity level of controls on ICoFR and report results of the test.

The interviewees state that ICoFR's Review is a relatively new activity in PT. NS since the ICoFR review was applied in 2013. This application has not been

[71] Interview with J, a manager-level auditor, at 3 September 2014

implemented in all SOEs in Indonesia. The interviewee also mentioned his / her motivation to implement the ICoFR review as follows[72];

> *We reviewed the ICoFR, because we are asked by the independent auditor whether we have done it or not. Reviewing ICoFR is done once in a year. Independent auditors are from the Big Four Group. They have the standard form set by their head office. In relation to the questions asked by the external auditor on the implementation of ICOFR, it is necessary for us to pay attention on it.*

Review of ICoFR aims to ensure that the figures recorded in the financial statements are valid and correct. ICoFR concentrates on control, in order to make sure that controls for each account have been implemented in order to prevent the overstatement or understatement or a wrong recording. This control is performed on all activities in each business process that generate figures as confirmed by an interview[73];

> *Internal Control over Financial Reporting includes various business processes, such as marketing, procurement, production and IT.*

In conducting the ICoFR Review, the internal auditors place their priorities as described by the interviewee below[74];

> *We would like to focus on the high risks first and controls. After that, we will review the mid-level risks and controls, if we still have time. But, we hope that we can take all the risks and its controls for review.*

A participant explained further regarding the guidance for ICoFR Review as follows[75]:

> *We are assisted by our consultant in making a guideline to review ICoFR. Our Consultant is Public Accountant AJJ. Consultant helps us for one year. They make the blue print and we use it as a base to make Standard Operational Procedure.*

The AAJ is affiliated with the international Public Accounting Firm, namely International RSM (www.republika.co.id, 2016).

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[72] Interview with J, a manager-level auditor, at 3 September 2014
[73] Interview with D, a middle-level auditor, at 21 October 2014
[74] Interview with D, a middle-level auditor, at 21 October 2014
[75] Interview with K, a middle-level auditor, at 25 September 2014

5.5.3.1.3.3. Audit of Partnership Program and Community Development

All SOEs in Indonesia are required by the Ministry of SOE to have social responsibility by nurturing Small Medium Enterprises (SME) and engaging with Community development. These programs are called *PKBL*. The *PKBL* Program consists of two different programs, namely *PK* and *BL*. *PK* stands for Partnership Program which is a partnership program of SOEs with SMEs. This program aims to improve the ability of small businesses to be strong and independent through the use of funds from the profit of SOEs. Small businesses are economic activities of the people that are small-scale and meet the criteria of net worth or annual sales and ownership as regulated in Decree of Ministry of SOEs No PER-05/MBU/2007. Partners are small businesses that obtain loans from the Partnership Program.

BL stands for Community Development Program. This program improves the social conditions of society by SOE through the utilisation of funds from the profit of SOEs. *BL* Program is an implementation of Corporate Social Responsibility (CSR) such as sport, competitions, marching bands, and reforestation activities. The *BL* program is defined and implemented by the trustees of the SOEs in the region. Patrons' SOE are SOEs that participate in Partnership and *BL* Programs. In PT. NS, the *PKBL* Program is managed by the Unit of *PK* and *BL* programs are directly under the supervision of the CEO.

Audit of *PKBL* Programs is carried out once a year and needs a month to perform the audit. A participant explained the *PKBL* audit as follows[76];

> *The scope of the PKBL audit includes assistance provided by the company and the partnership program. For CSR audit, we examine the process of procurement and the distribution of aid, whether targeted or not. For the Partnership Program, there are two criteria set by the Ministry of SOEs, namely the number of partners and the amount of money.*

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[76] Interview with K, a middle-level auditor, at 25 September 2014

The guidance used in performing the CSR audit is described by an interviewee below[77];

> *In doing CSR audit we are in compliance with the Decree of the Minister of SOEs and Accounting Standards.*

The auditors use the Decree of the Ministry as a guideline to undertake the audit. The Decree of Ministry of SOE determines that only particular SMEs deserve financial support. These SMEs must fulfil the criteria set by the Ministry of SOE, such as possessing net assets of a maximum of AU$20,000 or an annual sales maximum of AU$100,000 . However, one participant made a comment about the violation of the aim of the decree by saying[78];

> *There was an Event Organisation (EO), that received a soft loan through the Partnership Program. In addition, several key people in the community who have power to influence the public, such as the board member of a particular political party, as well as several wealthy businessmen also received loans.*

An example of the audit finding on the *PK* Program was mentioned by an auditor[79];

> *An EO have a turnover of one million (1,000,000AU $), but EO owes about fifty or two hundred million from the company. EO has not paid the debt for a long time, stucked. The owner of this EO has a special relationship with the chief executive. We've warned CSR unit about this case. We have also sent audit reports on the said matter to the chief executive.*

In terms of SOP for undertaking audit of the *PKBL* Programs, one interview revealed that[80];

> *There is no SOP to audit the PKBL programs. Because the audit is conducted in turn with other audit bureau.*

In performing audit of the CSR Program, the internal audit focuses on the effectiveness of the implementation of the Program. The standard of effectiveness

[77] Interview with D, a middle-level auditor, at 21 October 2014
[78] Interview with L, a middle-level auditor, at 20 October 2014
[79] Interview with L, a middle-level auditor, at 20 October 2014
[80] Interview with K, a middle-level auditor, at 25 September 2014

measurement is that the result of the program can be used by the community. The participants stated that the application of such program has not been effective, which means it has not yet achieved the expected goals. A participant explained an example of an audit finding on the CSR Program, specifically on reforestation program[81]:

> *There is a proposal to hold reforestation activities at a cost of hundreds of millions of Rupiah, already approved by CSR unit. But the fact is instead of reforestation activities as described in the proposal, they grow marijuana. I submitted this matter to the CSR unit. But the response from the CSR unit is that they never received the proposal. Things like this makes me headache.*

This is because some programs were not organised to meet the needs of society since the company did not survey the people's needs before running a program. Due to several of the previous year's CSR's programs being ineffective, in 2014, a guidebook for the survey of community needs was published. However, such survey will be conducted by consultants and based on these survey's results the CSR unit will provide training to the community. The auditors had different experiences in conducting *PKBL* audit. One participant had difficulty with auditee which was reflected in the following comment[82];

> *Repeated findings usually occur in the audit Partnership Program. To minimize recurrent findings are difficult because of the head of PKBL unit is a tough character. He has no respect to us. However, after he is replaced by another person, their performance become better, and they respect us. If we get the audit findings, they want all the cases can be resolved, it is called "case closed". The performance of the working unit depends on the attitude of their leader.*

An auditor explained the approach in performing the *PKBL* audit[83];

> *As for the Partnership Program we have never visited our partners or conduct a field audit. We did not have much time to do a survey to our partners. The audit process we do is based on existing documents. However, independent auditors do make observations on the partners and we assist them.*

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[81] Interview with L, a middle-level auditor, at 20 October 2014
[82] Interview with K, a middle-level auditor, at 25 September 2014
[83] Interview with K, a middle-level auditor, at 25 September 2014

5.5.3.1.4. IT Audit

The information system between a holding company and its subsidiaries, particularly cement manufacturers has been integrated using computer software named SAP for the Enterprise Resource Planning (ERP). The database is located in Jakarta. The internal auditors in both PT. NS and its subsidiaries examine the system every three months to ensure it works properly.

According to the participants, the IT audit is performed by the audit bureau of ICT. The bureau was officially established in February 2014. One participant explained the implementation of IT audit and its background for late application as follows[84];

> *IT audit has been conducted for two years. This is because we only recently have experts. He moved to the internal audit unit two years ago, and recently received a certificate CISA in January last year.*

The reason to establish the ICT audit bureau is revealed in the interview below[85];

> *The company's information technology systems are very large and important. Data centre is accessed by the holding company and four subsidiaries. If no examination on the information technology systems is conducted, it would fail the holding company and its subsidiaries to enter into those systems. If this occurs, it will cause huge losses for the company. Thus, the needs of the company are the main reason for the company to conduct an audit on the information technology systems.*

Nowadays, only the head of the bureau has Certified Information System Auditor (CISA). Moreover, the bureau only has two members of staff with expertise in database servers and PC service desks. The bureau lacks internal audit staff who are qualified in the application system, which forces the head of audit bureau to perform the audit on the system.

In the Internal Audit Plan of 2014 (RKIA), it is explained that the audit of IT includes a review of the effectiveness of risk mitigation and internal control in the

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[84] Interview with J, a manager-level auditor, at 3 September 2014
[85] Interview with N, a senior-level auditor, at 15 September 2014

business process of the IT department. The aims of IT audit are described by an interviewee below[86].

> *An audit on information technology – based systems aims to provide assurance to the top management that the information technology systems built and managed by the information technology unit have been operated correctly or not. If the information technology systems need to be improved, the internal auditor will provide advices to the information technology unit to materialize the management's expectations.*

The auditors also examine[87]:

> *I audited several risks and controls associated in information technology unit. I checked on the field whether internal controls that aim to address the risks have been done. Internal controls are the responsibility of the operating unit of information technology.*

If such control is not effective, the residual risk will still exist. So the auditees have to mitigate such risk. The participants explain further that the internal auditors set the audit plan and carry out the audit based on the list of risks. This list of risk is compiled by Governance, Risk and Compliance (GRC) unit.

The RKIA 2014 shows that the IT unit has eight risks and fifteen internal controls to overcome the risks as well as eleven risk mitigations. The internal auditors use COBIT, ITIL, Project Management and Good Corporate Governance as the framework for working guidelines. It requires two months to conduct the IT audit. Ideally, the IT audit activity should be conducted by the internal auditor before the external auditors.

Overall, the internal auditors examine the system to ensure that the system is working properly. Furthermore, the internal auditor will report whether or not the IT unit has worked very well, so they can guarantee that the system will be running well.

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[86] Interview with N, a senior-level auditor, at 15 September 2014
[87] Interview with N, a senior-level auditor, at 15 September 2014

5.5.3.2. Capex Audit

The Working Plan of Internal Audit 2014 clarifies that the capital expenditure (Capex) audit is a review of the effectiveness and efficiency of an implementation of risk mitigation and internal control in some Capex / strategic projects that are conducted by the government.

The Capex audit is regulated in the Standard Operating Procedures (SOP) of Project Audit 2010. This document is developed to advocate the requirements of various rules and regulations such as the Decree of Ministry of SOE, Decree of the Board of Directors and Internal Audit Charter 2012.

The scopes of a Capex audit as stated in this document includes accounting and finance, project control, engineering, procurement, construction and support activities. One participant explained the reason for conducting the Capex audit as follow[88];

> *We have many projects and investments. Sometimes, after making an investment, they do not do anything. So, we checked out the investments and policies. These checking are to ensure that the policy has been applied correctly and meet its objectives*.

Other participants explain the audit bureau that has responsibility to carrying out the Capex audit[89];

> *Capex Audit includes all of the company's investments whether the investment is running well or not. We at the engineering audit bureau do the reviewing on such investment. It took us three months to complete the Capex audit.*

It is stated in the SOP document that the project activities are conducted within specified commencement and completion dates and then the audit execution is adjusted to this time period. In general, it refers to one of these periods: six-month period, appropriate stages of the project as prescribed by the board of directors, or as the working plan of the internal audit. The audit team for conducting a Capex audit consists

[88] Interview with J, a manager-level auditor, at 3 September 2014
[89] Interview with E, a senior-level auditor, at 22 September 2014

of internal auditors from four audit bureaus, such as accounting and finance, engineering, commercial and ICT, as mentioned by a participant from accounting and finance audit bureau below[90];

> *I have ever been involved in a project audit. I examine the business supply process and sales.*

5.5.3.3. Special Audit

Undertaking special audit is regulated by the internal audit charter. The charter states that it relates to the investigation of irregularities of regulations. The Internal Audit Plan (RKIA) 2014 allocates the number of man-days anticipated to be required to complete a sudden assignment from top management without interrupting routine activities. The assignment of special audits can be made by the president director or the audit committee of the subsidiaries by conveying a special audit request to the president director and the audit committee of the holding company as described by the following comment[91].

> *If there is a request for a special audit, we will do it. For example, there is an indication of fraud. Usually such request is based on a report, which is later decided whether to be followed up or just drop it. We have a whistle-blower system. This could be a flag-carrier for internal control.*

The interviewee explains the stages of conducting the fraud audit as follows[92]:

> *An instruction to conduct an audit on a fraud comes directly from the top management to the chief of the internal audit unit. Then, the chief of the internal audit unit forms a special team conduct fraud audit. The Special Team investigate the auditee directly and the report of fraud audit shall be given straight forward to the top management without any clarification with auditee. In doing fraud audit, special team focuses to the problem.*

*T*he application of a special audit is guided by the Standard Operating Procedures (SOP) of Fraud Audit 2011. The SOP states that the objectives of a special audit are to assist the management to carry out his/her responsibility by providing an analysis,

[90] Interview with D, a middle-level auditor, at 21 October 2014
[91] Interview with J, a manager-level auditor, at 3 September 2014
[92] Interview with H, a middle-level auditor, at 20 October 2014

assessment, suggestions and comments over the activity which may involve fraud. The special audit comprises three actions: prevention, detection and investigation of fraud.

– Prevention of Fraud

At this stage, the internal auditor attempts to eliminate the causes of the emergence of fraud by maintaining a good internal control system and effective control activities as well as by improving the organisational culture through implementing good corporate governance and effective internal audit function.

– Detection of Fraud

Each type of fraud has its own characteristics, so discovering fraud needs a good understanding of the different kinds of fraud that may arise within a company. The feature of most supporting evidences of fraud may not be tangible. In general, an indication of fraud is by the appearance of symptoms such as changes of lifestyle or behaviour of a person, suspicious documentation, complaints from customers, and suspicion of colleagues.

– Investigation of Fraud

There is no further explanation concerning the fraud investigation in the internal document.

The special audit is not merely about fraud. Another type of special audit assignment could be the investigation of the deviation from as well as disobedience of the regulations.

The role of auditors principally is from an early stage. The internal auditor has to provide consultancy at the planning stage and to play the role of catalyst during the operation, then to provide an audit recommendation after the report has been audited. According to the participants, to be a consultant is not easy as they have to be more

knowledgeable than the auditee in operational matters so they can provide solutions to the problem they dealt with.

The internal audit activities cover three kinds of audit: operational audit, capital expenditure audit and special audit. Operating audit includes engineering audit, commercial audit, accounting and finance audit, and IT audit. These activities are in line with the Standards which require audit activities in areas of financial, operational, information technology, regulatory and strategic risks.

5.5.4. An Alignment of Purposes between Internal Audit and the Company

The internal audit unit of PT. NS has a Road Map included in the Annual Audit Plan (RKIA) 2014 to encompass the development of the internal audit function from 2009 to 2014. The roadmap is adjusted to the condition, need and the policy of the company. This is a process of integration between business processes and auditing. It is reflected in the usage of a List of Risks by the internal auditor as a guideline to do the audit by putting a priority on high risks of business process. The list is provided by each business unit and is coordinated by the bureau of Risk Management in Governance, Risk and Compliance. Nevertheless, the list does not guarantee that all risks in the business processes are covered. Normally, the internal auditors may find additional risks from various sources, such as observations in the field, interviews with the auditee, notification from other internal auditors from other audit bureaus, or from others.

These risks are divided into three categories of risks as explained by the participant below[93];

[93] Interview with P, a junior-level auditor, at 25 September 2014

There are three kinds of risks in a company. First, the enterprise's risks arranged by the whole working units. We ask the working units to understand their business processes and then consider all the risks that could cause the business processes stopped, the frequency of risks occurrence and the impact of such risks is it large or small? The second risk is the risk of ICoFR. ICoFR risk is the risks map and controls related to the financial statements. The third is health and safety risks specifically intended for the factory workers.

The interviewee provides an example of enterprise risks as follow[94];

So far we see that there is no problem in complying the rule. We comply all regulations, such as the regulation of Bapepam-LK/OJK, Corporate Law, Law of SOEs, capital market regulations, for violating regulations will cause high risks that will endanger the company. For example, we follow the regulations on the procurement of transportation, because if we break the rules, then the company will receive the sanction from the government. In this case, the top management is responsible for adopting any regulation by issuing Decree (SK) of the Managing Director and other Directors. In addition, we also have a legal department that is responsible to make all regulations are obeyed.

The interviewee clarified that the risks were important to be understood in order to determine their controls as reflected in this statement below [95];

Our task is to help the chief executive supervise the company to run effectively and efficiently. To that end, the company's activities must be controlled. Each activity has risks that must be controlled. We use risk list provided by the bureau of risk management and risk identified through field of audit. Then, we check whether those risks have been controlled or not.

In this case, the internal audit is an integral part of the company as mentioned by one participant as follows[96];

We hope that internal auditor could be partner of a working unit achieving the goal. This is the aim of our auditing activities. Other than that, also to achieve the goal of the company, such as increase the company's profit and "go international".

[94] Interview with J, a manager-level auditor, at 3 September 2014
[95] Interview with P, a junior-level auditor, at 25 September 2014
[96] Interview with L, a middle-level auditor, at 20 October 2014

5.5.5. Organisation and Reporting

As stated in the Charter, the internal audit unit in PT. NS is responsible to undertake audit activities on the operational expenditure within PT. NS and capital expenditures within the PT. NS group. Audits of the operational expenditure of the cement maker subsidiaries are conducted by their own internal audit units, and coordination among these units and the internal audit unit in PT. NS has been declared in the Charter. In practice, the participant explains this condition by saying[97];

> *The scope of the audit for internal auditors at PT NS, a holding company, include NS and subsidiary G. G is a cement manufacturer in Indonesia that does not have internal audit unit. Other subsidiaries PT ST and PT SP are also cement manufacturers, they already have internal audit unit. Thus, auditing in PT ST and PT SP are done by their own internal auditors. PT ST and PT SP Internal Auditors sent their audit reports to their president director and also to their audit committee.*

Another participant illustrated the position of internal auditor of PT. NS toward the internal auditor of subsidiaries as follows[98];

> *For example, holding company's internal auditors conduct an audit of the project. This project is owned by a subsidiary, particularly cement manufacturer located close to the subsidiary's office. But, we did not act as an auditor, but we act as a supervisor. We supervise the internal auditors in the subsidiary as they would generate audit reports. We know the issues that are there and we brought the issue to the holding company here. Later, we will discuss the issue with the board of directors.*

5.5.6. Policy and Procedure

In the Internal Audit Charter 2012, it is declared that the head of the internal audit unit has to create written policies and procedures including the Audit Manuals as guidelines for carrying out the tasks of internal auditors.

Review of the internal documents indicated that the company has possessed certain documents in relation to internal audit activities. They are the Guidance of Internal Audit 2014, the Procedures of Internal Audit 2014, and a number of Standard

[97] Interview with R, a middle-level auditor, at 22 October 2014
[98] Interview with J, a manager-level auditor, at 3 September 2014

Operating Procedures (SOP) that contain directions for conducting the activities of internal audit. However, the audit unit had not yet made SOPs for conducting the CSR audit as revealed in the subsection of audit of partnership and CSR program.

The hierarchy of such documents was described by an informant through an interview as follows[99];

> *The hierarchy are consecutively policy, procedure, and standard operation procedure (SOP). Policy is prepared by the chief executive and certain directors which is then specified in the procedure. The procedure is made through discussions between working units. Details are contained in SOP procedures made by each working unit. For example, the Internal Audit Charter is a policy for the internal audit unit, while the audit procedures related to other working units. In case of SOP to conduct an audit, they will be regulated by their respective audit bureau.*

Accordingly, it is declared by the informants that all internal documents are developed in reference to the International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA), Professional Standards for Internal Audit published by Consortium of Internal Audit Profession Organisations, Professional Standards of Public Accountants, Sarbanes-Oxley Act 2002, Law No. 19 of 2003, Law No. 8 of 1997, Decree of Ministry of SOE 2002, the Internal Audit Charter 2012, and Decree of the President Director and the Directors of particular fields.

In terms of having the written policies and procedures, the audit unit has follow the Standard by establishing a number of policies and procedures as guidance of internal audit activities, except for audit of the partnership and CSR programs.

5.6. People of Internal Audit

It is declared in the Internal Audit Charter 2012 that the head of internal audit unit has to be involved in the selection process and the development of the staff. This means that the head of the unit is responsible for appointing qualified auditors, providing required training and continuing education. In addition, the head of the unit is

[99] Interview with P, a junior-level auditor, at 25 September 2014

responsible for assessing the performance of the internal auditor every year as well as providing an opportunity to have a consultation about their performance and professionalism development.

5.6.1. The Organisational Structure of Internal Audit Unit

The Internal Audit Charter 2012 states that the internal audit unit is positioned under the president director in the organisation structure. Furthermore, the internal audit unit is led by a head of the unit. The audit unit has three sub-units called bureaus. However, the chart of organisation structure as well as the observation of the audit bureaus in the internal audit department demonstrates the presence of four audit bureaus. The different number of bureaus occurred since the Internal Audit Charter 2012 has still not been up-dated with the establishment of the new ICT audit bureau in the audit department. The bureaus are responsible for specific areas, such as accounting and finance, commercial, production and projects, as well as information technology. Each bureau is led by a head of bureau. The audit bureau of accounting and finance possesses four internal audit members of staff, while the commercial audit bureau has two members of staff of internal audit. The audit bureau of engineering has five internal auditors and the ICT audit bureau has two members of staff of internal audit. The four members of staff of internal audit are under the bureau of planning and development of internal audit. In total, there are 22 internal auditors. Sufficiency of the number of internal auditors in conducting their duties was revealed from the interview below[100];

> *I only have two auditor staffs. But, since we use matrix system, I can ask for help to the auditor staff from other audit bureaus.*

Other interviewee described internal audit duties and an available of the auditors as follow[101];

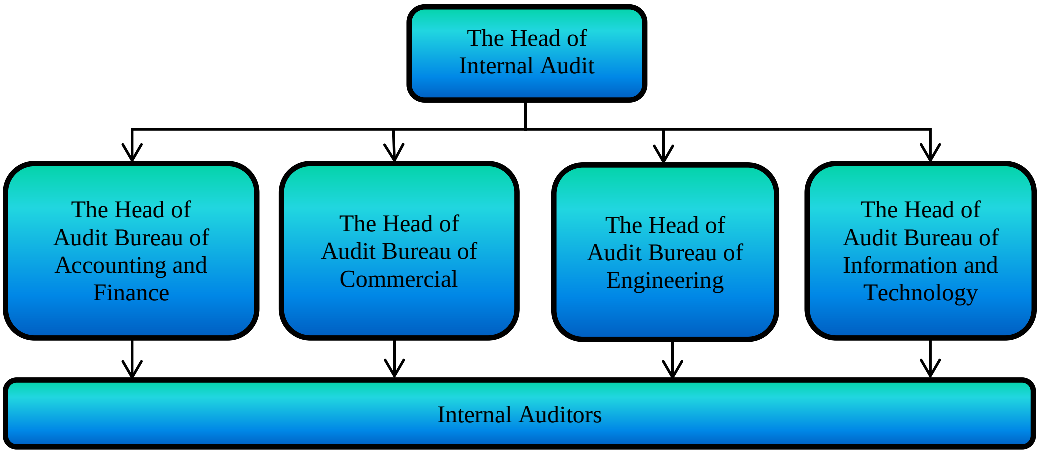
[100] Interview with F, a senior-level auditor, at 15 September 2014
[101] Interview with G, a senior-level auditor, at 15 September 2014

I ask all my auditors to review the ICOFR. I do not ask for help from other audit bureaus because they are too busy. We actually need more auditors to review the ICOFR because there are hundreds of controls that need to be reviewed. So, we focus on high risks and key controls.

Nevertheless, another participant had a different standpoint relating to an adequacy of internal auditors as mentioned below[102];

The matrix system is a solution to the lack of auditors. Auditors are limited, and we have to do a lot internal audit activities. Internal audit activities are carried out by some of the audit teams. An auditor can be a member of some audit teams. This is also the way we manage the time to be more efficient.

Figure 5.1. Matrix System



These four audit bureaus need internal auditors who have competence in their specific field. In order to possess such auditors with professional proficiency, the head of internal audit unit places attention on recruitment methods, trainings and certification, professional development and career planning of the internal audit staff. Some of the audit bureaus are struggling to apply the Professional Standards of Internal Audit which are required by the Internal Audit Charter of 2012. This Standard states that the internal audit unit needs to have personnel who collectively have the knowledge, skills and discipline required to perform audit tasks.

[102] Interview with J, a manager-level auditor, at 3 September 2014

5.6.2. Recruitment Method of Internal Auditors

The internal audit charter states that the Professional Standards of Internal Audit (SPAI) is used as guidance to recruit and assign internal auditors. It further states that the assigned internal auditors have to fulfil technical competence and certain knowledge criteria relating to the complexity of the audit.

According to the interviewees, basically, the recruitment is from internal sources by giving opportunities for staff from other departments who want to be an internal auditor, as mentioned by a participant below[103];

> *So far, internal auditors are recruited from other departments, especially the downhearted staff or outcasts. They are not needed at the other place and they are cast to the internal audit unit. I am both.*

The knowledge and skills in the particular fields as required by the Charter is essential since the functions of internal audit are related to a number of different disciplines, such as production, commercial, finance and IT. Thus, the internal audit team must comprise internal auditors who are capable and have experience in those fields. This is the main reason to recruit employees from other units. Employees who are recruited from other units have an understanding of the specific business processes in their units, particularly the internal controls and inherent risks. Besides, they are also able to identify weak points and problems in the business process so they are expected to know how to provide appropriate solutions. Therefore, the experience in previous departments will support their duties as an internal auditor. Nevertheless, the internal audit unit also recruited staff from external sources, though not many.

The internal recruitment system offers benefits to the recruited auditors as described by an interviewee below[104];

[103] Interview with M, a middle-level auditor, at 3 September 2014
[104] Interview with M, a middle-level of auditor, at 28 October 2014

> *The first time I moved to the internal audit unit of the IT unit, I felt there was problem. Before, I was the person who was examined by the internal auditor and now I am the internal auditor. I was confused with my new duties as auditor. But later, I was included in the auditing team and learn about the auditing process and got a training of Professional Internal Auditors (PIA) as well. Now, I really feel that my previous experience in the working unit really help me. Now, I feel confident to be an auditor as well as consultant.*

The using of internal recruitment system as a result from considers the competence of internal auditor recommended by the Standards. For example, the accounting principles and techniques expertise is required for auditors who deal with the financial statement audit, whilst auditors who are expert in information technology carry out audit the technology-based information systems. Internal recruitment is chosen since the internal audit unit could have internal auditors who understand the business processes and their risks as required by Standards.

5.6.3. Proficiency of Internal Auditor

The internal audit charter states that internal auditors have to obey the standards and the code of ethics in the charter. Also, the auditors have to possess knowledge and skills relevant to their auditing duties. These include capabilities in the application of standards, procedures, audit techniques, management knowledge and sound business practice. Also, the auditors are required to have abilities in oral and written communication to work effectively with the auditee and company management. The charter further states that the auditors have to participate in continuing professional development programmes such as training, seminars and conferences in order to update the development of internal auditing.

Through interviews with the participants, it is explained that the employees who are recruited from other units usually will be assigned to audit their former units as well as to handle consultancy and catalyst roles. In this case, the internal auditors should be able to demonstrate to the auditee that they have the proficiency to carry out their

functions, particularly the audit function, by showing a certification of professional internal auditor as evidence. Such certificates can be obtained through training organised by the unit. Moreover, the proficiency of internal auditors could be obtained via other means, such as conferences, seminars, sharing knowledge, and comparative study of the internal audit in other companies. Additionally, the internal auditor's experience in previous unit supports their function as a consultant for the auditees.

According to an interviewee, requirements of the competency of internal auditor had changed[105];

> *With this change from a watchdog to consultant as a form of a new internal audit paradigm, basically there is no change in demand in terms of the competence of internal auditor. Demands for an internal auditor competence at the application of the new paradigm are the same as the application of the old paradigm internal auditor. Only now, the internal auditor competence required to be more competent than the auditee. Why? Previously, an internal auditor simply showed the auditee's mistakes, but now the internal auditor should recommend something, starting from planning, implementation to evaluation. In the planning stage, internal auditors need to think comprehensively about what will an Auditee do. Auditors should provide something beyond Auditee's thought.*

Another participant mentioned the main change in competency requirement as follows[106]:

> *We are required to be one step ahead than the auditee, keep learning and be sensitive to the issues that arise. The main change is that internal auditor must get professional certification*.

Besides competencies in knowledge and technical audit, the auditors are required to have communication skills as mentioned by an interviewee as follow[107]:

> *Internal auditors should have competence and communication skills. Communication skills include oral and written communication.*

A participant described communication experiences with the auditee below[108]:

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[105] Interview with N, a senior-level auditor, at 15 September 2014
[106] Interview with M, a middle-level auditor, at 28 October 2014
[107] Interview with G, a senior-level auditor, at 15 September 2014
[108] Interview with Q, a middle-level auditor, at 24 September 2014.

I am facing various types of auditee. Some auditees are trauma to the style of the watchdog auditor. This type of auditee usually receives us with a negative mindset. Other auditee questioned my professional abilities, but the rest are nice to me. Facing this variety of auditees, I tried to convince them that I come to help them. I explain in a good way to the auditees that I have a professional certificate and I have followed an appropriate training. So, I tried to get closer to the auditee, but I keep myself independent.

In terms of written communication, the interview discovered as follows[109]:

We do not have a special standard to make an audit report. Before, we have a special template for making an audit report, but then such template would make the audit report inflexible. The audit report becomes too rigid and uncomfortable to read. But now, we do not use that template again. The audit report was compiled in a freestyle manner as long as the audit report represents audit recommendations. Complaints from the auditor relating to the freestyle audit report is a negative effect caused by the applied matrix system. An auditor can be involved in more than one audit team. Thus, the chairman of the audit team may have a different style of audit reporting. This creates confuse among the staff auditors.

5.6.3.1. Training and Certification

The charter requires internal auditors to have abilities to communicate effectively both orally and in writing to the auditees and also to management. They also must have sufficient knowledge to identify the existence of fraud. The auditors have to maintain a level of precision and alertness to the possibility of irregularities, inefficiency, ineffectiveness, and the weaknesses of internal control by conducting adequate and accountable testing and verification, although it is not necessary to be detailed in all transactions.

Likewise, the charter requires the auditor to maintain proficiency and due professional care. The competence are needed to define the level of materiality or significance of the problem, the level of reliability and effectiveness of internal controls, audit costs compared with the potential benefits and the existing of operating standards. The charter also requires non-cognitive competences. These are a flawless track record

[109] Interview with B, a senior-level auditor, at 15 September 2014

and reliable integrity as well as an understanding of their role as internal auditor and willingness to comply with the performance standard of duties and code of conduct.

As most staff are recruited from other units, therefore they have very little auditing knowledge. The internal audit unit overcame this issue by providing relevant training to the internal auditor. The auditing knowledge and skills are particularly needed by auditors who are assigned to audit bureaus of commercial, engineering and information technology. The auditors of the audit bureau of accounting and finance mostly have an accounting and auditing background. However, they also need to participate in training and obtain professional certification to prove their competence. Particularly for the internal auditors in the accounting and finance bureau, the Internal Audit Charter of 2012 has specified that they should have knowledge of the accounting principles and business processes, information technology and finance, especially for auditors who work extensively and in-depth with data and financial statements.

Training is a pre-requirement before an internal auditor obtains a certificate of competence to carry out tasks as required. Basically, there are two kinds of trainings provided by the internal audit unit. They consist of internal and external training. The internal training is obtained through a variety of media provided by the company or unit. The training provided by the head of internal audit unit is revealed through the interview as follows[110]:

> *The internal audit team comprises of accountant, production, IT and commercial staffs. My principle is that everyone can be an auditor. If you do not know about finance or production, let me teach you.*

In contrast, other participants faced problems with training the recruited internal auditors from other business units, as stated below[111]:

[110] Interview with J, a manager-level auditor, at 3 September 2014

[111] Interview with E, a senior-level auditor, at 22 September 2014

Most of the internal auditors in my bureau are recruited from other units. Actually, I got headache teaching them. If they have a bachelor degree, that makes it easier for me to teach them. But, if I get an internal auditor from the factory worker who continues their education to get a bachelor degree, it is rather hard for them to learn the theory. I have to tell them logics and directions to them.

Some of internal auditors are very keen to undertake the training as indicated by the following comment[112];

Sorry, the internal audit staff have different intention in participating the training program. Some of them really want to learn, but some of them just want to have fun. For me, rather than spending money to take a formal study I rather get a training program.

International and national external training is organised by professional institutions outside of the company that have their own schedule. This external training is explained by the interview below[113];

The Internal Audit Education Foundation (YPIA) regularly performs training. YPIA is in cooperation with IIA-Australia. The training covers various areas, such as risk and fraud. The training aims to give auditor a broader knowledge.

There was a company policy related to the trainings, as mentioned by a participant[114];

In a year, we often follow training programs. This is due to the company's policy that each individual auditor has minimum forty hours training. If less than forty hours of training, we are then considered as undeveloped.

In terms of international trainings, an interview revealed as follows[115]:

I had followed training in Australia and Germany. I have also attended IIA seminars and international conferences.

The interview also discovered problems faced by auditor staff in relation to attending international training, conferences and seminars, as mentioned below[116];

Auditor staffs need experience and knowledge. However, we also evaluate these auditor staffs. If they have the capability in knowledge, language and analytical aspects, then we will ask them to follow training, attend conferences and seminars at international level. Currently, there is no auditor from my bureau who is qualified.

[112] Interview with L, a middle-level auditor, at 20 October 2014
[113] Interview with J, a manager-level auditor, at 3 September 2014
[114] Interview with J, a manager-level auditor, at 3 September 2014
[115] Interview with E, a senior-level auditor, at 22 September 2014
[116] Interview with E, a senior-level auditor, at 22 September 2014

Another problem is that some of auditors face a dilemma since they an overloaded workload, which makes it difficult for the auditors to undertake training. This difficulty has an impact on the completion of training and obtaining professional certification, which in some cases has been taking many years.

Even though there is no explicit explanation regarding the professional certification in the Internal Audit Charter, the internal audit unit was really concerned about this matter. A participant mentioned the professional certificate as follows[117]:

> *I have a PIA Certificate and I should also have certificate for other profession, such as CISA, CIA and CRM. For me, certificates will enhance our knowledge and internal audit performance.*

On the other hand, the interview also uncovered the struggle of auditors to obtain the certification as follows[118];

> *It is not easy to get CIA Certificate. Our chief audit bureaus and the head of internal audit unit failed the test for CIA Certificate. I am asking myself can I pass the CIA test or not.*

Another participant mentioned that[119];

> *The chief of the internal audit unit should have a CIA Certificate. At least, a CIA certificate. I had once taken a CIA test and I failed. I failed in obtaining CIA certificate because in one other test field I scored less than required. The minimum score required is 75 and my test result was 74, though I got more than 80 for the other subjects.*

This situation is also proved by the Annual Audit Plan (RKIA) of 2014 which accommodated the requirement of Bapepam-LK/OJK No. IX.1.7. and the IIA recommendation in relation to the proficiency of internal auditors. Planning to improve the internal auditor's competence was based on the gap between the real competences of the auditors and the competences expected by standards and the Bapepam-LK/OJK requirement. Therefore, the Annual Audit Plan 2014 set training materials which included Internal Audit Control Self-Assessment, Information System Assessment,

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[117] Interview with Q, a middle-level auditor, at 24 September 2014.
[118] Interview with Q, a middle-level auditor, at 24 September 2014.
[119] Interview with J, a manager-level auditor, at 3 September 2014

Enterprise Risk Management, Fraud Examination, Value Chain Management, Psychology and Audit Communication, Finance and Taxation as well as Effective Report Writing. Targeted certification was also part of the Annual Audit Plan 2014. They comprised one Certified Control Self-Assessment (CCSA), two Certified System Information Auditor (CISA), four Certified Risk Management Professional (CRMP), one Certified Ethical Hacking (CEH), one Certified Internal Auditor (CIA), four Qualified Internal Auditor (QIA), and four Professional Internal Auditor (PIA).

Currently, internal auditors have some of the following certification: four PIAs, five QIA, one CRMP, and one CISA. The certifications that are still being worked for comprise four PIAs, three QIA and two CISA. Additionally, two internal auditors have not yet been certified. The Assessment Report of GCG Implementation in 2012 issued by BPKP also reported that many internal auditors possessed the professional certifications; PIA, QIA, CRM, CISA, and ISO. The report also stated that the head of internal audit unit has participated in the CIA Review Course.

5.6.3.2. Seminars

Seminars are intended to augment insight and knowledge through exchange of information including in the area of Accounting Management, Ethics & Fraud, Information Technology, Auditing and Industry Knowledge. There are many types of seminars: one of them is called the Communication Forum of the Internal Auditors (FKSPI) from all SOEs in the East Java Region. This is a knowledge sharing event for all internal auditors and is held once a year. According to one of the participants in an interview, the attendance of staff at the seminar depends on the permission of the head of the audit bureau. None of the internal audit staff in the audit bureau of engineering attended the seminar nor do the internal auditors in the finance and accounting usually go to the seminar. The internal audit staff in the accounting and finance audit bureau

who are involved in the management of FKSPI became inactive since the head of the audit bureau did not give permission to the staff to be more active in FKSPI. This is indicated by the following comment[120],

> *The chief of the previous audit bureau give some attention to the FKSPI organisation and its activities. Other than that, he is the vice chairman of that organisation. But the new chief of the Audit Bureau has a contradiction attitude to the previous audit bureau chief. The new bureau leader did not give me permission to participate in any FKSPI activities. The Chief said to me "what's the use for you to be active in FKSPI?" And I do not want to argue and I obey my audit bureau chief, although in fact I get insights and knowledge from other state-owned enterprises through sharing knowledge in FKSPI. Currently, I only focus on work, work and work. Only that.*

Another type of seminar is knowledge sharing and can be held by the internal company. This event aims to share knowledge among all internal auditors in the PT. NS. The seminars present some speakers from internal and external organisations, such as independent consultants, the head of the internal audit unit, and the audit committee. The speakers explain the recent knowledge, such as the internal control-integrated framework of COSO, International Professional Practices Framework (IPPF) of the IIA, and also how regulations have changed.

The interviewee mentioned the motivation to follow the COSO, IPPF and obey the regulations as follows[121]:

> *We use COSO, IPPF and obey all regulations because all these things are our guidelines for conducting internal audits. If auditee ask what is the basic of our audit, we can explain all of these guidelines to the auditee. So, we point auditee's mistake by definite basis, as well as our audit recommendations to them.*

The annual report 2014 states that the Control-Integrated Framework issued by COSO has been implemented in the company.

[120] Interview with L, a middle-level auditor, at 20 October 2014
[121] Interview with R, a middle-level auditor, at 22 October 2014

5.6.3.3. Conferences

Conferences are needed to recognise the development of internal audit function, audit scope, technology for auditing, latest audit issues, means of benchmarking with companies that are better in a specific area. The conferences are held by a number of institutions in Indonesia and overseas, such as the Institute of Internal Auditors (IIA) – Indonesia, Educational Foundation of Internal Audit (YPIA), and the IIA – International. There is a comparative study program within the activities of the conference. This program is a visitation of internal auditors to internal audit units in other SOEs in Indonesia or SOEs overseas as well as in private or public companies as expressed by the following comment[122];.

> *We conducted a comparative study organised by the Education Foundations of Internal Audit (YPIA). We have visited the Siam Cement Group and Oil Company in Bangkok, Thailand. The positive thing in their place that we cannot apply it here is their internal audit unit were under the board of directors. Thus, their internal audit unit are much more independent. The relationship between internal audit and management in their place is like the relation of parliament and the president.*

Another participant has different experience as follows[123];

> *We visited Telkom and also some overseas companies, such as companies in Melbourne, Australia, and oil companies in Malaysia. We learned how they control them, and how they perform their functions as assurance provider and consultants in accordance with the IPPF. We also learn about information technology and how to review the information technology-based data*

An interviewee explained the effort of the internal audit unit to improve quality by saying[124];

> *We make an Indonesian SOE listed on the NYSE and other companies as our benchmarks. We visited them and learn from these companies how to improve our company. We discussed these companies used as benchmark with the chief of internal audit unit.*

[122] Interview with N, a senior-level auditor, at 15 September 2014
[123] Interview with E, a senior-level auditor, at 22 September 2014
[124] Interview with D, a middle-level auditor, at 21 October 2014

Besides attending international conferences of the IIA, some of the internal auditors also became members of the IIA as mentioned by a participant below[125];

All Chief of the audit bureau are members of IIA.

The membership of the IIA is funded by the company. The internal audit unit seriously attempted to keep in line with proficiency criteria required by the Standards by obliging the auditors to attend training and acquire professional certification, and has sent a number of auditors to seminars and conferences in order to maintain and enhance their professional skills. However, some problems emerged during these efforts. The work overload created difficulty for auditors to manage their time to attend the trainings, and approval of the head of audit bureaus to attend the seminars was hardly ever obtained for some auditors. The internal audit unit also hired a competent consultant to assist them to set the SOP for ICoFR audit.

5.6.4. Career Development

The career of an auditor in the internal audit unit is measured by several levels or rank, such as the manager or the head of internal audit unit, senior auditor, auditor, and junior auditor. Generally, the career level of the majority of internal audit staff is auditor. There are four junior auditors, twelve auditors and five senior auditors in the unit. The junior auditor is equal to the team leader position at the careers level in the company, whilst the auditor is similar to the lowest manager level, and the senior auditor is equivalent to a head of bureau. There is a fit and proper test for promotion from the junior auditor to the auditor and so forth. The working experience of auditors ranges from very beginning to ten years, but only four auditors have experience of more than ten years.

[125] Interview with J, a manager-level auditor, at 3 September 2014

Recently, the participants said, the head of internal audit unit required human resources development (HRM) to give internal auditor candidates at least a the lowest manager level. This is because internal auditors encounter auditees of various ranks, from the lowest level to the top level. In order to ease the internal auditors in conducting their duties, they need to be respected by the auditee. Normally, the auditees particularly who have high position in the company, will ignore the internal auditors who are team leaders. On the other hand, the auditee respects the internal auditor with position of head of section. The mind-set of the auditee towards the internal auditors is a concern to the head of the internal audit unit, which then requested the Human Resource Department that any staff transferred from other units to the internal audit unit must have at least have a position as head of section. Likewise, it is planned to promote all those in team leaders' positions to head of sections. The reason behind this minimum career policy is explained by a participant as follows[126];

> *As I know, the human resources unit played a big role in my career. Also, the technique of my boss. My manager understands that the needs of a company for an internal audit is huge, so that the internal audit unit need of individuals who are not just a team leader level or junior auditors, but an audit unit requires a lot of qualified auditors. That is the reason why my career is increasing fast because the minimum requirement for an internal auditor is at the level of the chief of section or middle level auditor.*

In addition, the head of internal audit unit also required that any internal auditors that to be transferred to other units should be promoted to a minimum one level or higher.

However, not all participants have the same point of view concerning career planning. This was indicated in the interview that follows[127];

[126] Interview with M, a middle-level auditor, at 28 October 2014
[127] Interview with L, a middle-level auditor, at 20 October 2014

> *Career program is not clear here. I do not know how my career will be any further. I observe that employees who do not have an accounting background are placed in the accounting and financing unit as well. In addition, many of employees from the production unit are placed on marketing department. It seems that the company has no definite guidelines on this matter.*

In addition, there is a qualification required to reach the position of head of audit bureau. The requirement encompasses expertise in technical science, such as IT for the position of the head of audit bureau of ICT, mastering auditing knowledge, understanding of the professional character of the internal auditor and knowing the culture of the company. Similarly, the criteria for the head of internal audit position encompasses having experience of a minimum of fifteen years in units of organisations in order to understand the existing business process, and not all of this as an accountant. In PT. NS, the head of internal audit unit has an accounting background, thirty years of experience in units of organisation and five years in an internal audit unit. Also he has undertaken the CIA Review course though he has not received the certification yet.

5.7. Process of Internal Audit

According to the Audit Charter 2012, the audit process must conform to the following processes: preparing an Audit Plan, Executing the Audit, Reporting the result, and Monitoring the operations that follow up the recommendation.

5.7.1. The Audit Plan

The Internal Audit Charter 2012 states that the internal audit plan is a basis for conducting all activities of internal audit departments. Before conducting an audit, the internal auditors have to compose a risk-based internal audit plan (RKIA) that focuses on the business process and internal control. Also, such a plan has to be approved by the

head of the unit, then needs to be documented. It is illustrated by the following comment[128];

> *Each year, we make an action plan based on risk. All business processes in each unit has risks and controls. Risks and controls were then compiled by the unit in the form of risk list. Then, working units ask an approval from the directors of their fields based on the risk list. The next step is the working unit send the list of risks to the GRC unit. We receive the risk list from GRC unit and we look the level of risk. We received from the unit and we look the level of risk. It is impossible for us to take all the risk level as the material for our audit. So, we choose the risk at middle and high level as the object of the audit and our review.*

In conducting the research, the auditor should also collaborate with other units as mentioned in the following comment[129];

> *Internal auditors use the list of the risks submitted by the GRC unit and also the risks of ICOFR compiled by the Bureau of Financial Management. Based on the risk list, we conduct a review of its control. Practically we consider all the risks that are not mapped yet. So, we use the criteria from other sources, such as from Procedure. If we find a risk that has not been listed in the list of risk, we will inform the risks to the GRC unit and auditee as well.*

In terms of the accounting and finance audit, the internal auditors also consider other aspects in determining the focus of audit activities of the analytical review besides the given list of risk, as mentioned by a participant below[130]:

> *In conducting the analytical review of the financial statements, the focus of the analysis in every three months can be different. The difference arises because we consider the condition of the company. For example, we compare the financial statements of a certain period with the of previous year financial statement of the same period, and we concentrate on the significant differences, both increases and decreases reported figures.*

It should be noted that the internal audit unit maintains its Manual of Internal Audit Procedure 2014 that explains the Internal Audit Plan, Conducting Audit, and the

[128] Interview with J, a manager-level auditor, at 3 September 2014
[129] Interview with P, a junior-level auditor, at 25 September 2014
[130] Interview with H, a middle-level auditor, at 20 October 2014

Procedure of Special Audit. According to a participant, the audit plan should not be static, but needs alteration from time to time as indicated by the following statement[131];

> *In suggesting an internal audit activity program, we consider on many things such as internal auditor advance study, time for group, time for operation, time to change or improve system and time to share knowledges with all internal auditors of all subsidiaries. Those activities must be balance.*

The process of making an annual audit plan is initiated by each audit bureau in the internal audit unit. In composing the audit plan, every head of the audit bureau considers matters which encompass the list of risk and corporate risk profile, and the audit results from the previous year. The list of risks is released by the unit of Governance, Risk and Compliance (GRC). By using this list of risks and the additional information, the head of the audit bureau determines the focus of auditing through selecting high risks and their controls to be checked as well as deciding the amount of working time for conducting the audit and the number of the internal auditors.

The Charter (2012) indicated that the head of the audit unit has to obtain approval from top management and the board of director concerning the internal audit plan. The approval is a way to maintain the quality of the plan. In terms of this matter, the interviews demonstrated that the provision of an audit plan is crucial as it has to reach a high management level as indicated by the following interview[132];

> *We present audit plan before the CEO and audit committee in a separate occasion. We have done this because we want to give the CEO a chance to add or erase something he possible has as an additional consideration. However, all this time, the CEO always approve the internal audit plan. But we always set some spare time in a year anticipating for a special audit request in that year.*

[131] Interview with J, a manager-level auditor, at 3 September 2014
[132] Interview with J, a manager-level auditor, at 3 September 2014

In generating the plan, the availability of resources should also be considered as mentioned by the following participant[133];

> *From our perspective on the audit plan, we should consider the materiality level of an activity and also the risks arising from those activities associated with the company. For example, is the production quite important? Yes, it's important, because if production stops or inefficient, then the company cannot sell the products. If the company does not produce anything, then the company does not get any profits. Therefore, in conducting an audit of production, we focus on equipment, systems and people involved in the production process.*

The Charter states the content of the annual audit plan which covers goals and objectives that have to be accomplished; scope of activities; working schedule; indicators of activities performance; a number of assigned internal auditors; necessary external experts; the budget of internal audit activities; and the reports of activities. This was confirmed by the annual audit plan 2014 which contained an internal audit road map, an organisational structure of internal audit, the audit and consulting activities, non-audit activities, the schedule of internal audit activities, the budget of internal audit, the KPI of internal audit, the flowchart of internal auditing and its appendix which includes training need analysis and list of risks. Furthermore, the Assessment Report of GCG Implementation in 2012 issued by BPKP presented that the human resources department cooperated with the internal audit unit have been made a necessity analysis of internal auditor.

In terms of the accomplishment of the internal audit plan, the interview indicated as follow[134];

> *Annual Audit Plan must be done completely because its approved by 3 parties, the audit committee, the president director and the chief of internal audit unit. If its performance is not 100 percent reached, then questions will be raised by an external auditor.*

[133] Interview with J, a manager-level auditor, at 3 September 2014
[134] Interview with B, a senior-level auditor, at 15 September 2014

The interview results are supported by an internal document, the Annual Audit Plan 2014, which contained ten business processes: marketing, procurement, information technology system, manufacturing and its efficiency, capital expenditure; cement factory projects and packing plant, ICoFR, Analytical Review, and CSR. All these business processes have 61 risks and 395 controls that need to be audited. Also, there is scope to conduct special audits.

Once the plan is approved, the unit needs to develop an audit program guided by a document named Procedure of Internal Audit 2011. Again, the audit program needs to be checked and approved by the head of internal audit unit.

The internal audit unit has been using a risk-based audit plan which was in conformity with the Standards. This plan demands internal auditors to put priority on high risks and their controls. Besides, the audit plan was approved by the CEO and the audit committee as required by Standards.

5.7.2. Performing the Audit

As presented in the Charter 2012, the internal auditors must collect, analyse, interpret and document the information to support an audit assignment. In practice, the internal auditors need to meet the auditee when conducting the audit process, as mentioned by the participant below[135].

> *We must interview the auditee, ask them to provide documents or give us reason for all they have done.*

The audit activity is guided by the Guidance of Internal Audit 2014. In performing the audit, the internal auditors will compare the criteria and the real condition as explained by a participant[136];

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[135] Interview with J, a manager-level auditor, at 3 September 2014
[136] Interview with P, a junior-level auditor, at 25 September 2014

In conducting the audit, we have criteria and real conditions. Criteria consist of legislation, regulation, decision of the Director, Procedures, Standard Operating Procedures, best practices, such as COBIT and risk-based matrix control published by the GRC unit. The matrix control includes overall control in the company. In addition, we also use a special risk-based matrix control for ICOFR issued by a financial management unit. Auditors compare criteria and conditions. If there are any discrepancies, they should be reported to the auditee, Unit GRC and the financial management unit shall also to be improved.

In terms of guidance in carrying out the audit process, an auditor explained below[137]:

We use COSO, IPPF and comply all regulations because all these things are our guidelines for conducting internal audits. If the auditee questions on what basis we make our audit recommendations, then we can explain it to them. So, we remind auditee on auditee's mistake on a definite basis, likewise with our audit recommendations.

In more detail, the interviewee illustrates the auditing process from setting an audit plan to writing a preliminary audit report as follow[138];

Our audit process is already standardised. So our audit approach is risk-based audit. At the time we made the internal audit work plan (RKIA), we gather all of the risks and controls. For example, we collect 2,000 controls, and then we consider our resources, including staff of internal auditors. If human resources are not adequate to check the 2000 controls, then we will select 1000 controls of high risk only. Further, risks and 1000 controls that have been selected are distributed to the respective audit bureaus. For example, commercial audit bureau must audit the 200 controls of the procurement process. The next process is that we sent a control self-assessment (CSA) questionnaire to each unit and we requested the working unit (auditee) to do a CSA based on their risk list. Auditee would make a check-list of the controls that have been made to address the risks with proofs. The check-list and also proofs should be returned to us for our review. The two items will become our evaluation and consideration in auditing in the field. For example, the controls are not implemented by the auditee or applied but not enough proof as the object of our audit. Furthermore, we conduct a field audit to gather evidence through observation or collection of documents. Then, each of the internal auditors will record the results of observations, review the documents and evidences in a Working Paper Examination (Audit Working Papers) as basis for preparing the preliminary audit report.

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[137] Interview with R, a middle-level auditor, at 22 October 2014

[138] Interview with P, a junior-level auditor, at 25 September 2014

An outline for a complete auditing process from setting the audit plan to writing a final audit report is demonstrated through interview below[139];

> *Outline of the audit process is that we have the internal audit plan. This is the basis to establish an audit program and audit schedules. Then, we make the audit procedures. After that, we sent the CSA questionnaire to auditee. Auditees do CSA and fill out the CSA questionnaires. CSA questionnaire are then returned to us for our review. The next step, we conduct a field audit, preliminary audit report writing and request an auditee's response. The last stage, we held a meeting for clarification with the auditee that produces a number of audit recommendations, and then prepare a final audit report.*

Before undertaking the auditing process, internal auditors analysed the adequacy of the internal control system through the CSA questionnaire before testing its effectiveness, as required by Standards. Moreover, during the process, there were meetings among junior and senior auditors and the head of audit bureau to discuss the findings or any issues emerging in the process as suggested by the Standards. In performing auditing, the internal audit team consists of a number of auditors who are expert in the areas being audited, such as information technology, accounting, and business process, as suggested by the Standards. As the auditors are recruited internally from other business units they have sufficient experiences to understand business operations including risks and its control. This understanding supports the auditors in conducting risk-based audit activities as well as in consulting by giving the applicable audit recommendations.

5.7.3. Reporting the Results of the Audit Assignment

The Internal Audit Charter 2012 requires that internal auditors should report the results of their assignments. The final audit report should contain objective findings, conclusions and applicable recommendations as agreed to with the auditee to be

[139] Interview with P, a junior-level auditor, at 25 September 2014

followed up and approved by the head of internal audit unit. The content of a preliminary audit report was explained through the interview below[140];

> *The audit report must contain at least observations, implications and recommendations. Observations include the real conditions and we have to find the root cause of the problems that arise. The real conditions and then we compare it with the criteria. Thus, the condition is the result of our observation, while the cause is something that makes these conditions occur, and criteria are guidelines or standards. Conditions should be in accordance with the criteria; if not, then the condition is the audit findings. The implication is the result. Thus, the condition creates results. The latter is the audit recommendations. So, these three aspects are the content of the preliminary audit report. This report was sent to the auditee, then, we held a meeting for clarification with the auditee to discuss the preliminary audit report. The meeting will produce an audit recommendations agreed by auditees and internal auditors. Based on the results of this meeting, we produce the final audit report with audit recommendations as an additional component.*

The Charter specified criteria of audit recommendations, such as being rational, complete, accurate and on time. An auditor commented on the audit recommendations below[141];

> *It is important to give an audit recommendation that could be applied rather than a theoretical audit recommendation. We must introspect ourselves that when audit recommendations are not followed up by the auditee could be because such recommendations cannot be implemented. Sometimes, auditors only ask auditee to follow up the audit recommendation without considering the difficulties faced by auditee in implementing it. Because we sell our recommendations to the auditee, we have to understand their condition.*

After the final audit report is published, the interviewee explained the next procedure as follows[142];

> *After the final audit report is approved by auditee, the report is then signed by the chief of the internal audit unit and we return it to the auditee.*

In terms of distribution of the internal audit reports, the Internal Audit Charter 2012 states that the audit reports have to be delivered to the CEO and also the

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[140] Interview with P, a junior-level auditor, at 25 September 2014
[141] Interview with L, a middle-level auditor, at 20 October 2014
[142] Interview with E, a senior-level auditor, at 22 September 2014

independent board of directors or the audit committee. For this matter, an interviewee described the reporting line as follows[143];

> *According to the Internal Audit Charter, audit report simultaneously delivered to the Audit Committee and the CEO.*

The head of the internal audit unit delivered the final audit report to the auditee, the senior management and the audit committee. The reports to CEO and the audit committee are described in the organisational independence section. The CEO received complete information, while the audit committee received information which had already filtered down from the CEO. This mechanism is opposite to the Standard's suggestion that the audit committee should be informed of all audit findings raised by the internal auditors.

5.7.4. Follow-up Monitoring

The Internal Audit Charter 2012 explains that internal auditors should monitor the follow-up actions which are conducted by the auditee based on the recommendations of the audit report. If the auditees do not follow-up the audit suggestions due to certain considerations, then they should be reported to the related directors. Regarding the action taken by the auditee, it was mentioned that[144];

> *Most of the auditee follow up the internal audit recommendation. Some of them have difficulties to solve their problem but that is especially caused by something beyond their control. We have to check case by case.*

Another issue relating to monitoring follow up audit recommendations is explained by an interviewee as follow[145];

[143] Interview with L, a middle-level auditor, at 20 October 2014
[144] Interview with E, a senior-level auditor, at 22 September 2014
[145] Interview with L, a middle-level auditor, at 20 October 2014

> *I did a Partnership (PKBL) program audit and found sixteen findings. From these findings, only one audit recommendations are followed up by the auditee, and obviously it did not become a problem. Auditee's attitude will depend on the attitude of the leaders, especially if middle managers get the support of the top management. Audit findings related to top management will only become mere findings. So, our contribution as an internal auditor is vague.*

In terms of follow up of audit recommendations from top management, an auditor stated that[146];

> *The duty of an internal auditor is to be a catalyst and convey information. So, will the chief executive follow up the information being submitted or not, it's up to him. This is true. Our job is simply to provide information*

In addition, there are three purposes of activity of follow-up monitoring that are contained in the internal document, the Standard Operating Procedures (SOP) of Follow-up Monitoring 2011. Firstly, ensuring follow-up measure carried out by the auditee are well documented. Secondly, making sure that the findings of audit are followed up in accordance with the schedule and commitment that has been set so it does not happen again. Thirdly, report and communicate the monitoring results to the auditee, top management or audit committee, consistent with the internal audit charter.

Additionally, the procedures for conducting the follow up monitoring that are included in a SOP consist of several steps. Firstly, the audit findings are abstracted into a monitoring report format with the title information, date of follow-up plan and the current status. Secondly, monitoring is performed by auditors for at least 3 months by reminding the auditees by phone, email, and formal letters with a copy to each relevant high ranking manager. Thirdly, the monitoring results are reported to the interested parties no more than 6 months later and specifically reported to the relevant management if there is no appropriate follow up by the auditee.

[146] Interview with M, a middle-level auditor, at 28 October 2014

The participant illustrated the detail of the procedures for the practice of follow up monitoring, as follows[147];

> *To monitor the follow-up made by the auditee/working unit on our audit recommendations, we make a record based on the audit findings. So, one observation is one point. Observations include a brief description of who is the Person in Charge (PIC) of the auditee, any follow-up action conducted by the auditee, when is the due date of such follow-up, and what is the evidence of the follow-up. We made a note on the data. After auditee gave proof to us, then we change the auditee status to "Closed" meaning that the audit recommendation has been done good by the auditee. We put all the information to the website, until everyone can see whether the audit findings are followed or "closed" or not. Our website is Key Performance Indicator – Follow up Monitoring (KPI-MTL). This is the internal audit website that monitor the followups of auditee. If auditee does not implement the audit recommendations of internal auditors, it will give an impact on their KPI. The KPI will be linked to incentives for auditee. Thus, the system will force the unit to follow up the audit recommendations.*

In terms of monitoring follow up audit recommendations, the audit unit set it in the audit charter and put it in the SOP and applied it in the practice as revealed through the interview. This situation indicates that the audit unit has kept in line with the recommendations of the Standards.

5.7.5. Quality Assurance Review

The Internal Audit Charter 2012 declares that the head of the internal audit unit has to establish and implement a quality assurance system to evaluate the performance of the unit, in order to obtain reasonable assurance that the performance of internal audit has been in accordance with auditing standards, the charter and other provisions. For that purpose, it must be done as follows:

- External review is conducted at least once every three years by the experts and capable parties / institutions, independent of the company, who have no conflicts of interest to assess and provide an opinion on compliance of internal audit to the auditing standards and other applicable requirements.

[147] Interview with P, a junior-level auditor, at 25 September 2014

- Periodically internal review by management to assess the effectiveness of the audit and compliance of the auditors to audit standards, codes of conduct, policies and other applicable regulations.
- Continuous supervision from the planning, implementation, evaluation and reporting until follow-up audit recommendations.

Further description of these Quality Assurance Reviews is presented below:

5.7.5.1. External Quality Assurance Review

The internal audit unit has completed an external Quality Assurance Review (QAR) periodically by using an independent and competent assessor, as mentioned by a participant below[148];

> *Nobody has done an audit on internal audit. Therefore, we asked external parties that are PwC and BAI to do the Quality Assurance Review (QAR). So far we have twice done the QAR. The lack of certified internal auditor is the result of QAR, the next QAR should be done this year, but because of a general audit, it will be done earlier in this year by an external auditor, then the next QAR will be postponed, that is next year.*

Another participant mentioned that the external QAR is required by the IPPF as follows[149];

> *The external QAR was done about 3 years ago by Bina Audita Indonesia. As far as I know, the external QAR is only done twice. The International internal auditing rules set out in the IPPF, stipulates that the external QAR is carried out at least three and a half years and it was later revised to five years.*

The focus of each QAR was described by the participant below[150];

[148] Interview with J, a manager-level auditor, at 3 September 2014
[149] Interview with F, a senior-level auditor, at 15 September 2014
[150] Interview with J, a manager-level auditor, at 3 September 2014

PwC assessed the Audit upon Procedures. It relates whether these procedures have been applied or not. After that, in 2011, BAI did the QAR covering all aspects of the IPPF. Similarly, the Audit Board of the Republic of Indonesia (BPK) conducted tests on the company's internal control and the score we get is 95 of 100. BPK assesses designs, the existence and implementation of control and its flexibility. In addition, BPK also observe how the internal auditor conducts tests on control and whether the auditor followed the Standard Operating Procedures for testing.

The external QAR was last conducted in 2011 by PT *Bina Audita Indonesia* (*BAI*) before SG transformed to PT. NS. An internal document of the QAR's Report explains that QAR activity is a review of the internal audit function and all of internal audit activities at SG. The review which is conducted by BAI includes activities during the period after the previous QAR, in 2008, to 2011, with an emphasis on activities and conditions during the past year. The Report of QAR explains further that there are four aims of QAR activity in PT. NS. Firstly, it evaluates the effectiveness of internal audit in providing assurance and consulting services to the board of directors, and top management. It identifies internal audit opportunities to improve performance and add value to the organisation. It improves the image, perception and credibility of internal audit. It establishes the suitability of internal audit work with the International Professional Practices Framework (IPPF) Standards from the Institute of Internal Auditors (IIA) and best practices. This QAR uses the IPPF as an evaluation basis. If the BAI focused on all aspects of internal auditing contained within the IPPF in undertaking the QAR; an accounting firm, PwC, and The Supreme Financial Audit (BPK) focused on certain valuation, namely Audit upon Procedures.

BPK as the independent auditor of government does not have a routine schedule to audit PT. NS as the State-owned Enterprise. In addition, the Financial and Development Supervisory Agency (BPKP) for East Java Provincial Representatives carried out an assessment towards the implementation of Good Corporate Governance

(GCG) of PT. NS in 2012. The period of review is January to December 2012. BPKP assessed six aspects of GCG: continuous application of corporate governance, the Annual General Meeting (AGM), the board of director, the top management, and disclosure of information and transparency.

In this GCG's review, the internal auditing is also evaluated since it is under the responsibility of the CEO. As stated in the GCG Report, some aspects of internal auditing were evaluated: the internal audit charter, the position of internal audit in an organisation structure, a recruitment mechanism for and qualification of the head of internal audit unit, direct access to the audit committee, the reporting line, management of internal audit staff, the competence of internal auditors, the guidelines for audit activities, a program of Quality Assurance Review.

5.7.5.2. Internal Quality Assurance Review

According to the Internal Audit Charter 2012, the internal QAR should be conducted by management through performing supervision toward the auditing process, from planning to following-up audit recommendations. However, there are diverse understandings among the participants on the internal QAR, and most stated that there was no internal QAR, as follows[151];

> *There is no evaluation from the internal party regarding the internal audit. But there is a review from the external party toward the internal audit.*

Besides, the CEO is believed by other participants to be another appropriate internal party to conduct an evaluation of internal audit. Nevertheless, the president director never performed the internal QAR upon the internal audit unit, as mentioned by a participant below[152];

> *The director never evaluate the internal audit.*

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151 Interview with F, a senior-level auditor, at 15 September 2014

152 Interview with H, a middle-level auditor, at 20 October 2014

The internal audit unit has been partly following the Standards, in terms of performing quality assurance and implementing an improvement program for internal audit activity. In this case, the unit has been conducting an external review of quality assurance periodically using independent and competent institutions, but the internal review of quality assurance has not yet been carried out.

5.8. Summary

The findings of the case present the practice of internal audit in PT. NS. The interview and relevant documents indicate that the Indonesian auditing standards are used as a basic reference in undertaking the practice. The International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA) is also employed as the guideline in auditing practice. Interestingly, the Indonesian auditing standards were adopted from the standards issued by the IIA.

The findings from the case indicate that the auditing practice follows the global development of internal auditing which is brought about by the IIA. This is reflected in the alteration of the internal audit functions. The functions changed from watchdog into three main functions: audit function, consulting and catalyst. The new functions require significant changes to some aspects of auditing such as the understanding of the auditor of their new functions, competences of the auditors, and the way of performing audits. However, the new functions may put the independence of auditors at risk.

The interview and the documents point out the struggle of the internal audit unit to undertake the new functions and the important aspects mentioned above. In this case, the auditors attempt to follow the recommendations from the IIA by adopting those that are in the Internal Audit Charter and implementing those in practice. However, there are a number of violations from the auditing standards of the IIA. First, there is an interference from management in the audit report. Second, some of auditors also work

as operational staff, particularly as treasurer for CSR activities. Third, there is no SOP to audit the CSR program. Fourth, the recruited auditors lack knowledge and experience in the auditing field. Fifth, obstacles emerged in implementing the professional development program. Sixth, the auditors have no support from the CEO in conducting follow up monitoring for certain cases. Seventh, there is no internal QAR undertaken to assess the quality of the internal audit activity.

Thus, the findings from the case indicate that the practice of internal auditing in PT. NS is still partly in line with the standards of the IIA.

Chapter 6
The Effect of Institutional Pressures to the Internal Audit Practice

6.1. Introduction

The previous chapter presented a case study of the practice of internal audit in the context of a public State-Owned Enterprise (SOE) in Indonesia. This chapter uses institutional theory to analyse the changes revealed in the previous chapter and to assess the firm's commitment to change.

Institutional theory suggests that to obtain legitimation, an institution may have to change in response to a range of pressures. As suggested by DiMaggio and Powell (1983), there are three mechanisms of institutional isomorphism that encourage an institution to change: coercive, normative and mimetic isomorphism. There are different pressures resulting from each of the above that require an institution to change (DiMaggio and Powell, 1983; 1991). An institution may respond strategically to the pressure when moving toward change. Oliver (1991) offered five ranges of strategic responses to pressure: acquiescence, compromise, avoidance, defiance, and manipulation. Each strategy has at least three different tactics.

This chapter contains identification and analysis of the pressure experienced by the SOE from each source and examines the strategy used by the SOE to respond and change. Analysis of how and why the SOE unit under study responded will also be discussed in this chapter using the five ranges of strategic responses as suggested by Oliver (1991).

This chapter consists of five sections: introduction, coercive isomorphism and the practice of internal auditing, normative isomorphism and the practice of internal auditing, mimetic isomorphism and the practice of internal auditing, and a summary.

6.2. Coercive Isomorphism and the Practice of Internal Auditing

Institutional theory suggests that to obtain legitimation, an institution may have to change. There are three mechanisms of institutional isomorphism that encourage an institution to change (DiMaggio and Powell, 1983): coercive, normative and mimetic isomorphism. Regarding coercive isomorphism, the pressure may come formally or informally (DiMaggio and Powell, 1983; 1991). Accordingly, formal source of pressures stem from legal sources and other standards which may include: the government mandate, law, legitimated rules and structures, and Standard Operating Procedures (SOP). Similarly, Arena *et al.*, (2006) pointed out examples of Italian companies listed on the NYSE which had to respond to formal pressures from laws such as the Sarbanes-Oxley Act. Informal pressure may come from outside organisations which the institution relies upon administratively and culturally (DiMaggio and Powell, 1983; 1991). A number of scholars have classified the source of coercive pressure in to different categories such as international, national and industry levels of pressure (Paauwe and Boselie, 2003); industry and listing pressures (Arena and Azzone, 2007), and pressure from a profession (Fogarty, 1996). However, this study uses the formal and informal category developed by DiMaggio and Powell (1983). The study is conducted on an internal audit unit of a public state-owned enterprise in Indonesia. The ownership of the company is 51% government and 49% private. There are two sources of coercive pressures experienced by the unit internal audit unit examined and these are, formally, from government mandates, and informally, from private requirements and expectations, such as from the Institute of Internal Auditors (IIA), the Sarbanes-Oxley Act 2002 (SOX), the Committee of Sponsoring Organisations (COSO), and the International Organisation for Standardisation (ISO) 26000.

This study executes two levels of investigation on how and what actions are taken by the unit in response to coercive pressures. In order to identify the response, the first stage of examination is conducted by investigates a media that accommodates the requirements of the pressure. This study will use various facts from the data collection. The documentation of the audit charter is used as the first level of investigation to explore the response of the audit unit to the institutional pressure by accommodating or not accommodating the regulations in the Internal Audit Charter. The Audit Charter is an appropriate starting point because it is a formal written document that defines the purpose, authority, and responsibility of the internal audit unit. The second level of examination is to investigate the practice of the audit by interviewing various members of the audit staff in relation to the relevant regulations. This will demonstrate the importance of investigating the issues documented by the Charter and showing what was really practiced by the internal audit unit as suggested by Fogarty (1996). Fogarty (1996) emphasises the distinction between the formal organisational structure demonstrated to the external environment they should accomplish and actual organisational practice. The model of investigation used by this study is presented in figure 6.1 below.

Figure 6.1. Coercive Pressures towards Internal Audit Practice.

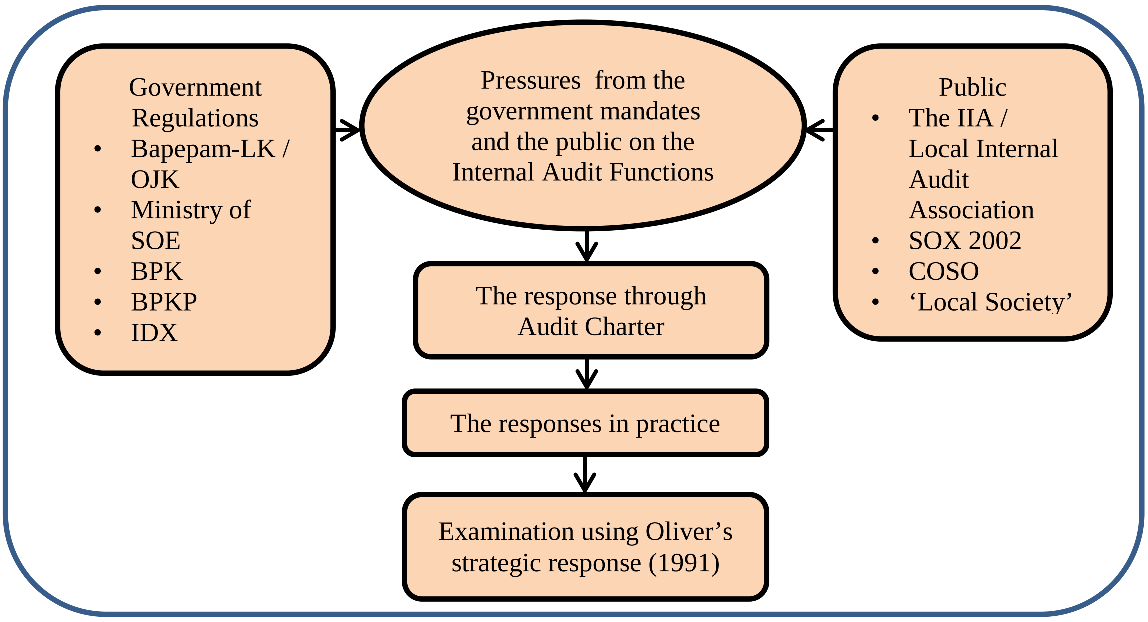


Figure 6.1. depicts two main sources of coercive pressure dealt with by the unit: government mandates and the public. The government mandates consist of four regulations set by the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) and the Indonesia Financial Services Authority (OJK), the Ministry of State-Owned Enterprise, the Supreme Financial Audit of Indonesian Government (BPK), the Financial and Development Supervisory Agency (BPKP) and the Indonesian Stock Exchange (IDX). These regulations are directly and indirectly imposed upon the internal auditing practice. There are four sources of informal pressure from the public as presented in figure 6.1 above. Firstly, the Institute of Internal Auditor (IIA) and the Indonesian internal audit association expect the auditor to comply with the code of conduct of internal auditors. Secondly, the external auditors (international affiliated public accountants) recommended the internal auditor comply with SOX 2002 by undertaking an audit on Internal Control over Financial Reporting (ICOFR). This was to ensure that the company practiced good corporate governance. Thirdly, the external consultant recommended the internal auditors review the internal control system using guidance issued by COSO. Fourthly, ISO 26000 also puts pressure on the internal auditors to monitor the charity program conducted by the company.

Having described the possible pressure from formal and informal structures, this study will investigate the firm's response using five ranges of organisational strategic responses developed by Oliver (1991). Each pressure will be discussed in the subsections below.

6.2.1. Pressure from Formal Structure

As a hybrid entity which operates as a public company as well as being owned by the government, the unit under study may experience pressure from various sources. The pressures investigated by this study from formal structures are the stock market regulator (Bapepam-LK/OJK), Ministry of SOEs, Government Audit Unit of BPK and BPKP.

6.2.1.1 The Bapepam-LK/OJK Regulation and the Responses of Internal Auditors

Bapepam-LK is a government institution which is similar to ASIC (Australian Securities and Investment Commission) in Australia. In 2011 Bapepam-LK, the stock market regulator was replaced by a new institution, namely OJK, which has a function like that of Bapepam-LK but also supervises the Indonesian Financial Transaction Reports and Analysis Centre (PPATK), an institution that monitors the flow of money in the country that is similar to Austrac in Australia. In 2008 Bapepam-LK issued regulation No: KEP-496/BL/2008 that details the requirements of the role of internal auditor in public companies. This regulation is considered to bring pressure on the internal audit of public companies. Investigation of the Internal Audit Charter of the company indicates that almost all requirements of the regulations are listed in the Audit Charter, except some small items not presented in the charter but practiced by the auditors. This means that the unit investigated complies officially with all items of the regulation. In order to understand how and why the unit responded to pressure from this regulation, further investigation was undertaken using the interview data, observation, relevant internal documents and reports from external institutions. This revealed the implementation of the charter in practice and investigated the audit practice using five strategic responses developed by Oliver (1991).

The result from documentation and interviews as presented in chapter 5 indicated that the unit being investigated uses four strategies to respond to pressure: acquiescence, compromise, avoidance and defiance. These four strategies were used with different tactics in regard to different items of the regulations as presented from table 6.1 to table 6.4.

Table 6.1. Items responded to using Acquiescence strategy and Comply tactic

Regulation of Bapepam-LK/OJK
1. The public company is required to have an internal audit unit
2. The public company must own the Internal Audit Charter set by top management and approved by the board of directors.
3. The Charter has to state the definition of internal auditing and describe the functions of internal audit, the assurance provider and the consulting functions.
4. Code of Ethics of internal audit refers to the national or international Code of Ethics of Internal Audit.
5. The structure and position of internal audit unit in public company: a. The internal audit unit is led by the head of internal audit. b. The head of internal audit is appointed and dismissed by the CEO and approved by the board of directors.
6. The duties and responsibilities of internal audit unit: a. Set an annual internal audit plan. b. Examine and asses the efficiency and effectiveness of financial, accounting, operational, human resources, marketing, information technology and other activities. c. Recommend improvement and objective information on the activities being audited to all levels of management. d. Cooperate with the audit committee. e. Perform special audits if necessary.
7. The authority of the internal audit unit consists of: a. Access to all relevant information of the company. b. Regular and incidental meetings with the company.
8. Qualifications of the internal auditor: a. To have communication skills. b. To keep confidential information and company's data related to the internal audit duties, except as it is required by legislation or court.

6.2.1.1.1. Strategic Response of Acquiescence to Bapepam-LK/OJK's Regulation

According to Oliver (1991), acquiescence means compliance with institutional pressures and may appear as three tactics namely comply, imitate, or habit. The comply tactic means obeying regulations and rules consciously, while imitation means mimicking a successful organisation, and habit means unconsciously following invisible and taken-for-granted norms. There are sixteen requirements listed in the Bapepam-LK/OJK regulations. The analyses of these requirements are presented in table 6.1 to 6.4 in this chapter. From the documentation, it was found that nine of the requirements

have been accommodated in the audit charter. In addition, the interview data as presented in chapter 5 also indicated that the items listed in the audit charter are actually and consciously practiced by the auditors. With such findings, it could be argued, therefore, that the audit unit is using the acquiescence strategy and comply tactic in response to the requirements of the Bapepam-LK/OJK regulations. Two reasons for such a response were given in the interviews. Firstly, as a state-owned entity, the unit has to comply with government regulations. Secondly, as a public company, the unit investigated has to comply with Bapepam-LK/OJK's regulation as a stock market regulator.

6.2.1.1.2. Compromise Strategic Response to Bapepam-LK/OJK Regulation

The compromise strategy is defined by Oliver (1991) as a strategy to respond to a situation when there is a conflict between internal and external demands in relation to efficiency. This strategy may be applied in three different ways or tactics such as balance, pacify, and bargain. The balance tactic is used to balance demands of multiple constituents. The pacify tactic is used to please and it contains a variety of institutional elements. The bargain tactic is used to negotiate with institutional stakeholders.

Two Bapepam-LK/OJK regulations from table 6.2 were represented in the Internal Audit Charter. However, from the interviews it was revealed that these requirements were only partially followed by the internal audit unit. Therefore, it could be said that the internal audit unit is using the compromise strategy and pacify tactic.

Table 6.2. Items responded to using Compromise strategy and Pacify tactic

The Regulation Bapepam-LK/OJK
1. The duties and responsibilities of internal audit unit: a. Set the program to evaluate the quality of internal audit activities.
2. Qualification of internal auditor: a. Must have integrity, professional behaviour, independence, and be honest and objective in performing their duties. b. Has knowledge and experience in the audit with both technical and other relevant knowledge. c. Understands the capital market regulations and other legislation. d. Obeys professional Standards issued by the Internal Audit Association. e. Understands the GCG principles and risk management. f. Is willing to increase their professional knowledge, skill, and capabilities continuously.

Such strategy and tactic may be based on good reasons. The legislation requires the internal audit unit to set the program to evaluate the quality of internal audit activities. However, it is not clear whether this should be done by an external or internal party as indicated by an internal audit standard issued by IIA (IIA, 2013). In response to this requirement, three evaluation activities are presented in the Audit Charter. Firstly, an evaluation is to be made of supervision from the stage of the audit plan to the audit recommendations. Secondly, there should be an internal quality assurance review, which is a review of audit activities conducted by a unit external to the internal audit unit, and thirdly an external review is to be made by a body external to the company.

The interviews revealed that supervision was well implemented for some stages; audit planning, and audit execution. However, the review of the audit recommendation was not fully implemented as some items that were considered to be sensitive were interfered with by top management. The interviews also revealed that there was no internal QAR performed upon the audit activities. Since it was the head of the unit who was asked to do this, no explanation was obtained. In terms of external evaluation, an interview revealed that the audit unit is reviewed by external, independent and professional institutions every three years. The external institutions are Bina Audita Indonesia, the accounting firm, PricewaterhouseCoopers and BPK. The interviews indicated that the response of the unit toward the pressure of such regulation is to use

the compromise strategy and the pacify tactic. The findings on the QAR practiced by the unit under study brings new aspects to the institutional theory in relation to internal audits as an addition to previous studies by Al-Twaijry *et al.* (2003), Arena and Azzone (2007), Arena *et al.* (2006), and Mihret *et al.* (2012). By doing so, it highlights the importance of investigating the differences between what was documented by the Audit Charter and what was really practiced by the internal audit unit as suggested by Fogarty (1996). Fogarty (1996) emphasises the distinction between the formal organisational structure demonstrated to the external environment they should accomplish and the actual organisational practice.

In relation to the qualifications of the internal auditor, there are six criteria. Firstly, the internal auditors are required to have good character, which should include integrity, professional behaviour, independence, honesty, and objectivity in performing their duties. This requirement is included in the Audit Charter. However, the fact that management may still interfere with the audit function indicates that the auditors could not apply absolute standards of independence. They may be independent with regard to the auditee but not to the management when asked to cover sensitive matters that may impact on management. Failure to maintain objectivity and independence will put their integrity and professional behaviour in question and violate the standards of a profession. The auditors have to retain independence (Chun, 1997; Hughes, 2004; Messier and Schneider, 1988; Rittenberg and Purdy, 1978), including independence from management interference (Bou-Raad, 2000; Chun, 1997; Courtemanche, 1986), and be objective (Bailey *et al.*, 2003; Carmichael *et al.*, 1986; Courtemanche, 1986). But the internal auditor cannot be totally independent from central management as they are part of the management control structure of the company. Therefore, it could be argued that the unit under study used the compromise strategy and pacify tactic in

response to pressure from the Bapepam-LK/OJK on the independence of internal auditor. According to Oliver (1991, p. 153) the pacify tactic constitutes "partial conformity with the expectations of one or more constituents."

There are some studies conducted on the violation of the independence of internal auditors using institutional theory (Al-Twaijry *et al.*, 2003; Arena *et al.*, 2006; Mihret *et al.*, 2012). Since most of those previous studies investigated independence in terms of who received the audit report in the manner approved by IIA, this study added a contribution by investigating the independent and objective norms by looking at the accommodation of the standards and regulations into the Audit Charter and actual implementation of the charter, as suggested by Fogarty (1996). Fogarty (1996) emphasises the distinction between the formal organisational structure demonstrated to the external environment they should accomplish and actual organisational practice.

The second criterion required by the regulation is "to have knowledge and experience on the audit techniques and other relevant knowledge" and it has also been adopted by the Audit Charter. However, the interviews indicated that it was partly complied with in practice. In recruiting the auditor, the head of internal audit faces a dilemma to comply with the requirement. Some auditors have accounting and auditing backgrounds and are assigned to the Accounting and Finance Audit Bureau. However, some auditors were transferred and recruited from other units and these mostly do not have a formal education in accounting and auditing. The educational backgrounds of these auditors are marketing, engineering, economics, and information technology. Since the auditors are mostly recruited from other units, they have no experience in audit techniques. Therefore, it can be said that the audit unit is using the compromise strategy and pacify tactic to deal with this pressure. The reason to recruit auditors from other units is to have auditors that have understanding and experience of the nature of

the business units where they came from. This capacity is needed to identify business risks and to establish a control system for the unit.

Understanding business processes is critical to the auditors as they implement a risk-based audit. Knowledge in audit techniques also can be acquired from training, evidenced by professional certificates such as Professional Internal Auditor (PIA), Qualified Internal Auditor (QIA), Certified Information System Auditor (CISA), and Certified Internal Auditor (CIA). These professional certificates are compulsory for the auditors and required by the head of the internal audit unit, although at this stage, the head of the unit has not yet obtained the CIA certificate.

The response of the internal audit unit toward pressure from Bapepam-LK/OJK regulations makes a contribution to the understanding of the internal audit practice. This study uses a different approach from previous studies (Al-Twaijry *et al.*, 2003; Arena *et al.*,2006; Arena and Azzone, 2007; and Mihret *et al.*, 2012). This study tests pressure from government regulation (Bapepam-LK/OJK), which requires qualifications specifically in accounting and auditing. A study by Al-Twaijry *et al.* (2003) only focused on the educational level without going into detail on the relevant discipline such as accounting and auditing. The study of Arena *et al.* (2006) focused on the requirement of SOX Act 2002 and Italian legislation concerning the qualification of internal auditors who assist in internal control of financial reporting. This study takes a different approach by investigating the practice of internal audit in a broader sense and by not being limited to the role of internal auditors to assist internal control over financial reporting.

Arena and Azzone (2007) discovered that the response to the recommendation of the Italian chapter of IIA on the qualification of auditors was to provide training and certification such as Certified Internal Auditor (CIA) and Certified Accountant (CA).

However, that study did not describe clearly the educational background of the auditors nor their experiences. In contrast, the current study examines educational background. Furthermore, this study differs from the study of Mihret *et al.,* (2012) that did not describe the auditors' qualifications, educational background or professional certification, nor the experiences of auditors in auditing and the relevant knowledge.

The third criterion required by the regulation is to understand capital market regulations and other legislation. This knowledge is expected to be used by the auditors as guidance in their activities to audit the public company. It is found that this criterion is accommodated in the Audit Charter. The interviews revealed that the majority of the auditors are using the regulations as guidance in conducting the audit function. Since we know that management interfered with the audit report, this seems to imply that the regulation was not fully applied in practice when preparing the audit report. In relation to CSR activity a similar situation also occurred. The auditors understand that in the context of supporting small businesses with micro-finance a small business is one with a maximum turnover of A$ 100,000. In practice, it was found that the company violates this regulation by distributing funds to firms that have a turnover of more than A$ 100,000. In an interview it was mentioned that the auditor who reported this finding in the audit report did not receive feedback from management, and therefore the auditors could not monitor the response and finally could not fully comply with the regulation. All these cases are examples where the auditors use the compromise strategy and pacify tactic that constitute partial conformity with the expectations of one or more constituents.

This study contributes to an understanding of the response towards the requirement concerning the qualifications of the auditors in terms of their knowledge and understanding of stock market regulation and other regulations where the auditee

operates as a public company. No previous study went in to such detail on the pressure dealt with by the audit unit under investigation (Al-Twaijry *et al.*, 2003; Arena *et al.*, 2006; Arena and Azzone, 2007; and Mihret *et al.*, 2012). In addition, this study investigates the difference between what is written in the Audit Charter and what really is being done in practice as suggested by Fogarty (1996).

The fourth criterion is that the regulation requires the auditors to obey the professional standards issued by the internal audit association. The audit unit responded to this requirement by officially and explicitly pronouncing it in the Internal Audit Charter. Again as indicated by interference of management in the provision of audit reports, this requirement was not applied in practice. Other incompliance in practice is also indicated by the absence of Standard Operating Procedures (SOP) to audit CSR project, as well as the absence of internal quality assurance reviews as discussed previously. It could be argued that the internal audit unit under investigation uses the compromise strategy and pacify tactic by not fully practising the requirements. Again, this study contributes to an understanding of the difference between what is written in the audit charter and what is practiced in carrying out the audit function as suggested by Fogarty (1996). Fogarty (1996) emphasises the distinction between the formal organisational structure demonstrated to the external environment they should accomplish and an actual organisational practice. This type of investigation has never been done by previous studies.

The fifth criterion is the requirement for the auditors to understand Good Corporate Governance (GCG) principles and risk management. This requirement has been adopted in the Audit Charter. The understanding of GCG leads to the area of risks and controls which require the capability of internal auditors to assess the internal controls over financial reporting (ICoFR). In the case of CSR regulations that were

violated on in terms of the eligibility of small business to receive funds, management did not comment on the audit finding and this kind of omission in the preparation of audit reports may increase a company's risk toward irregularities. This condition demonstrates that the internal audit unit carries out the compromise strategy by using the pacify response that constitutes partial conformity with the expectations of one or more constituents.

Previous studies such as by Al-Twaijry *et al.* (2003) and Mihret *et al.* (2012) did not investigate the understanding of the GCG principle on the practice of internal auditor to assess the ICoFR. Arena *et al.* (2006) examined the role of the GCG principle on the practice of internal auditor however they only involved the first level of organisation structure within the internal audit department and did not go in to detail for middle and lower levels and therefore could not reveal the practice. Another study by Arena and Azzone (2007) found the internal audit unit used the framework of COSO and Enterprise Risk Management (ERM) to verify the effectiveness of the internal control system. However, there was no further investigation of the application of risk management or internal control in their study. Having described the case found by this study, it can be said that this study brings a greater understanding of the response of the institution to the pressure. Although the auditors have enough understanding of the GCG principles and risk management, it may not be fully applied in practice.

The last item requires the auditors to increase their professional knowledge, skill, and capabilities continuously. This requirement is responded to by adopting it in the Audit Charter. From interviews it was interpreted that this item is met by attending international and local seminars and conferences. However, in practice, not all of the auditors had the opportunity to attend an event, particularly with international seminars or conferences because of a language barrier. Furthermore, the interviews also

uncovered that some internal auditors who are members of the Internal Audit Forum of SOEs (FKSPI) were not allowed by the head of the audit bureau to attend a seminar of FKSPI because it was considered 'useless'. This situation indicated that the unit partly applied the requirement in practice and therefore the unit is using the compromise strategy and pacify tactic.

6.2.1.1.3. Avoidance Strategic Response to Bapepam-LK/OJK's Regulation

According to Oliver (1991, p. 154) the Avoidance strategy is related to "…the organizational attempt to preclude the necessity of conformity." This strategy involves three ways: conceal, buffer and escape tactic. The conceal tactic is associated with the response to disguise the fact that it does not intend to implement the requirement using rational plan (Oliver, 1991, p.154). The buffering tactic refers to an "…attempt to reduce the extent to which it is externally inspected, scrutinized, or evaluated by partially detaching or decoupling its technical activities from external contacts" (Oliver, 1991, p.155). According to Oliver (1991, p.155) the escape tactic means "…an organization may exit the domain within which pressure is exerted…or significantly alter its own goals, activities, or domain to avoid its necessity of conformity altogether."

As presented in table 6.3 below, there are four items of Bapepam-LK/OJK regulation that are adopted in the Audit Charter. Regarding the number of auditors, there is no specific number required by the regulation. From observation and documentation it was found that the unit employs 22 staff that comprise one head of the unit, four heads of audit bureaus, one employee at a similar level to the head of the audit bureau, and 16 auditors. The auditors are spread across four audit bureaus: accounting and finance, commercial, engineering and ICT. Among 16 auditors, only 4 staff possess an accounting background and are placed in accounting and finance audit bureau.

Table 6.3. Items responded to using Avoidance strategy and Conceal tactic

The Regulation Bapepam-LK/OJK
1. The numbers of internal auditors should be appropriate to the size and complexity of company.
2. The structure and position of internal audit units in public company: a. The head of internal audit is responsible to the CEO.
3. The duties and responsibilities of the internal audit unit: a. Test and evaluate the implementation of internal control, and risk management in accordance with the company's policy. b. Compose the audit report and deliver it to the CEO and the board of director. c. Monitor, analyse, and report the follow up to audit recommendations.
4. The internal audit unit has authorities to: a. Communicate directly to top management, the board of directors, the audit committee, and their members

Some interviewees mentioned that their unit lacks internal auditors. When this condition was presented to the head of the unit, it was argued that the number of auditors were appropriate as all of the jobs were handled effectively. The head of the unit said that the unit was using a matrix system which means every bureau can use auditors from other bureaus. The explanation given seems to be senseless since each auditor is assigned to a bureau that is relevant to his or her expertise or background. An auditor from the accounting and finance bureau will be incapable of helping a bureau to undertake an engineering audit for example. In addition, some interviewees mentioned that they were overworked. This condition demonstrates that the internal audit unit actually has a shortage of auditors, but the head of the unit tried to hide it using a matrix system. After this investigation, it can be said that the unit disguises the fact of not implementing the practice and covers staff shortages with a rational argument about the matrix system. It is undertaken by asking assistance from the audit bureau in conducting the internal audit activities. Therefore it can be said that this unit is using the avoidance strategy with conceal tactic. This finding contributes another example to the literature of institutional theory of how the avoidance strategy and conceal tactic are used in practice. The number of internal auditors in the internal audit unit essentially is not appropriate with the size and complexity of the company, but the internal audit unit overcomes this problem by implementing the matrix system rather than recruiting more auditors. The

number of auditors in appearance looks sufficient even though in fact there is a staff shortage.

The second item is about the structure and position of the internal audit unit in a public company being responsible to the CEO. This requirement is clearly adopted in the Audit Charter. In practice, the response of the internal audit unit toward this requirement can be traced to the internal document of organisational structure of the company. However, this practice created an effect on reduces the level of independence of auditors in which it is also a requirement of the auditors' qualification (see table 6.2 above). Since the audit unit is under the CEO, the chance of interference of management in preparation of the audit report and the conduct of the audit is likely. As indicated by an interviewee, before an audit report is sent to the Board, it is seen by the CEO who often requires changes to the items reported. Furthermore, Internal Audit Standard number 1110.A1 (IIA, 2013, p.17) states that "the internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating the result." Since the interference of management was asked in the interview, it was argued that since the audit unit is under the CEO they have to obey instructions from the CEO. Therefore, it is clearly shown that the response to this pressure, the audit unit is using the avoidance strategy and conceal tactic to cover their lack of independence by using the Bapepam-LK/OJK's regulation as a rational argument. This finding is a new contribution to the area of institutional theory as it indicates a response of an audit unit toward institutional pressure using the avoidance and conceal tactic.

As presented in table 6.3, the third item of the regulation is about the duties and responsibilities of the internal audit unit in the public company that consist of three components. This item is contained in the Audit Charter which states that the

requirement is officially agreed upon to be applied by the unit. The first component is the requirement to perform the test and evaluation of internal control and risk management. However, due to lack of auditors, the head of the unit decided to perform these tasks only within staff availability. The interviews also discovered that auditors focused on high risks and their key controls and examined other controls if they still had time. Furthermore, a problem also occurred in reviewing ICoFR in that auditors are needed with accounting and auditing background but there are only four staff available with this training. Using the argument of implementing the matrix strategy that allows each bureau to use auditors from another bureau seems to be used as a rational argument to disguise nonconformity as characterised by the conceal tactic. The second component is that the auditors are required to compose the audit report and deliver it to the CEO and the Board of Directors (BOD). Implicitly, the purpose of sending the report to the Board is to keep the independence of internal auditors in presenting their opinion (Courtemanche, 1986; Driessen and Molenkamp, 1993; Sarens, 2009). However, the interviews revealed that the management had screened the audit report by eliminating abnormalities before it was sent to the audit committee of the Board. In this case, the reason for auditors to obey management instructions was that the position of the audit unit was directly under the CEO in the organisational structure and responsible to the CEO. This circumstance indicates that the internal audit unit responds to the pressure from Bapepam-LK/OJK with the conceal tactic, using organisational structure and attachment to CEO as a logical argument to cover non-compliance to the Bapepam-LK/OJK requirement.

The last component of this item requires internal auditors to monitor, analyse, and report the follow up of audit recommendations. From an interview it was apparent there were some Corporate Social Responsibility (CSR) cases which had been reported to the

CEO by the auditor, but the follow up of recommendations was never monitored. The reason why auditors failed to monitor the CSR cases was that those cases related to the CEO. The management interference meant audits were unsuccessful since internal auditors could not undertake their duties, particularly in monitoring the follow up of audit recommendations for some CSR cases. Thus, the interference of management indicates that the response in practice of the audit unit to the Bapepam-LK/OJK requirement is that it uses the conceal tactic. The response is categorised as the conceal tactic as the auditors use the organisational structure and accountability to the CEO as a logical argument to cover the non-compliance.

The fourth item of the regulation allows the internal auditors to communicate directly with top management, the board of directors, the audit committee, and their members. The direct interaction with the board is regulated by the internal audit standard number 1111 (IIA, 2013, p. 17) as part of the independence and objectivity of the internal auditor. This intention should also be the essence of the regulation of the Bapepam-LK/OJK. However, the Audit Charter requires the communication to be conducted through scheduled meetings so that the management can control the topic to be discussed with the board. The interview revealed that a meeting with the audit committee was scheduled every three months, and additional meetings were arranged if necessary. The response to the requirement indicates a strategy of the avoidance and using conceal tactic using the SOPs of scheduled meetings as the logical argument to lessen the independence of internal auditors as well as widen the distance of communication between the internal auditor and the board.

6.2.1.1.4. Defiance Strategic Response to Bapepam-LK/OJK Regulation

According to Oliver (1991, p. 156), the defiance strategy is "…a more active resistance to institutional processes". This strategy may take three forms: dismiss, challenge and attack courses of action. The dismiss course of action is characterised by "ignoring institutional rules and values" (Oliver, 1991, p. 156). The challenge course of action is described as "…offensive in defiance of these pressures and may indeed make a virtue of their insurrection" (Oliver, 1991, p. 156). The last course is the attack course of action which is indicated by "…the intensity and aggressiveness of the organization's active departure from institutional pressures and expectations" (Oliver, 1991, p. 156). There are two items of Bapepam-LK/OJK's regulation as presented in table 6.4 below that were responded to by the unit under study using the defiance strategy and dismiss tactic.

Table 6.4. Items responded to using Defiance strategy and Dismiss tactic

The Regulation OJK / Bapepam
1. It is forbidden for internal auditors to work as operational staff in holding and subsidiaries companies.
2. The internal audit unit has authorities to: a. Coordinate its activity with the external auditor's activity.

Both items are listed as part of the requirements in the Audit Charter. The objective of the first item clearly relates to the Internal Audit Standard No. 1120 in relation to Individual Objectivity (IIA, 2013, p. 18), which states "Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest". The conflict of interest is interpreted in the Internal Audit Standard as:

> Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interest can make it difficult to fulfil his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively (IIA, 2013, p. 18).

Interviews revealed the surprising situation that some auditors were holding positions as treasurers for CSR programs. In addition, it was also mentioned that a high ranking official in the internal audit unit held a position as a board member of a subsidiary company. When the position as a board member was questioned further, it was mentioned that the subsidiary was not significant in size. The violation had brought concern from independent assessors who conducted the Quality Audit Review (QAR) so that this issue had been reported in the QAR report 2011. Although it has been reported, there was no effort by the audit unit to resolve the matter. Nevertheless, the finding indicated that the practice of auditors had violated the first item of the regulation. Since the Bapepam-LK/OJK's regulation has been adopted in the Audit Charter, it means that the Audit Charter becomes an applied regulation. The violation of this regulation is clearly indicated to be a response of 'ignoring institutional rules and values,' which is characterised by the dismiss tactic of the defiance strategy.

The second item of the regulation is stated in the regulation as part of the authority of the internal auditor to coordinate its activities with the external auditor. The objective of this regulation can be found in the Internal Audit Standard number 2050 about Coordination which stated that;

> The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts (IIA, 2013, p. 28)

This regulation has been narrowed down in the Charter as part of the scope of work of the internal auditors to play their role as a counterpart to external auditor. The external auditors for the unit under study are considered auditors from various institutions. The external auditors can be from a public accounting firm who conduct the audit and report it in the company's annual report, from the Financial Development and Supervisory Agency (BPKP), an internal auditor of the government that assess the

implementation of good corporate governance, from the Supreme Financial Audit (BPK) (a government external auditor institution that executes financial audit as required by the Law of SOE 2003), or lastly from the independent assessors who undertake the Quality Auditing Review (QAR).

The interviews revealed that there was no coordination of internal audit activity between the internal and external auditors. There is no exchange of information between internal and external auditors in relation to what has been done by internal auditors. Rather, the internal auditors tend to protect information about their audit findings by saying that the audit finding is confidential to external parties. The internal auditors therefore, only perform their function as a counterpart by providing data excluding the internal audit report, accompanying the external auditor to visit a site or providing staff for conducting the audit. This practice is contrasts greatly with the code of conduct of auditors stated in the Audit Charter number 429 (SI, 2012, p. 21) as;

> To report all internal audit result by disclosing the truth that is based on the facts and do not conceal any issue that may impair the company and/or breach the law and regulation.

The practice of this item of regulation indicates that internal audit unit undertakes the dismiss response to the legislation. Using internal audit charter and how it is practiced (Fogarty, 1996) the study finds that the internal audit unit uses the defiance strategy and dismiss tactic to respond to the requirement of coordination with external auditors. Previous studies, Al-Twaijry *et al.* (2003) and Arena and Azzone (2007) did not investigate this matter. Mihret *et al.* study (2012) did not explore in detail regarding the coordination between the external and internal auditors of Ethiopia SOEs.

Arena *et al.* (2006) revealed relationships between internal and external auditors in Italian companies. The first group of companies investigated was found not to have regular collaboration, coordination or exchanges of information between the internal

and external auditors. The second group was found to communicate with external auditors but were limited to verbal communication without having a formal report. The third group was found to exchange information between the two since external auditors exploited the information collected and actively gave advice and recommendation to internal auditors.

6.2.1.2 Decree of Ministry of SOE and Internal Auditing Practice

Another regulation that creates institutional pressure on the internal audit unit under study comes from the Decrees of Ministry of SOE. One of the decrees investigated by this study is the requirement to implement Good Corporate Governance (GCG) which has to be assessed by an independent assessor. The independent assessor for the company under study is the Financial Development and Supervisory Agency (BPKP), an internal auditor of the government.

There are 32 items of the decree with detailed requirements for the internal audit practice to comply with. When these items were traced to the Audit Charter all of the items were recorded by the Audit Charter, but they were responded to differently in practice. Using the strategic response of Oliver (1991), the response of the unit to this particular pressure can be classified into three strategies: acquiescence, compromise and avoidance strategy. Each of these strategies will be discussed in detail below.

6.2.1.2.1. Acquiescence Strategic Response to the Decree of Ministry of SOE

As mentioned by Oliver (1991) the acquiescence strategy means the institution obeys the regulation by a tactic of: comply, imitation, or habit. The comply tactic is a situation where the institution is obeying regulations and rules consciously. The imitation tactic is where the institution is mimicking a successful organisation. The

habit tactic is the response taken by obeying the regulation unconsciously following invisible and taken-for-granted norms.

The first strategy of the acquiescence was found from interviews as presented in chapter 5, that indicated that the auditors executed the twelve items of the regulation in practice (Fogarty, 1996). These items are presented in table 6.5. Since these items are accommodated by the Audit Charter as well as implemented in practice, it means that the internal audit unit responded to these twelve items by using the acquiescence strategy and comply tactic. It could be said that the practice of internal auditing for these items are in line with the expectation of the regulator.

Table 6.5. Items responded to using Acquiescence strategy and Comply tactic

The Decree of Ministry of SOE
1. The SOE is required to have an internal audit unit.
2. The Charter is stipulated by the top management and approved by the board of directors.
3. The content of Internal Audit Charter must be: a. In line with Bapepam-LK/OJK Regulation and Company Law.
4. The Charter has to be reviewed and up-dated if necessary.
5. The head of internal audit unit is appointed by the CEO and approved by the board of directors.
6. The internal audit unit has to make a plan for the necessity of its auditor staffs.
7. The qualities of internal auditors are appropriate to undertake internal audit activities. a. The internal auditor staff possess knowledge, skills, and are required to have appropriate professional certificates. b. Having proper quality of internal auditor professionalism.
8. The internal audit unit has a quality assurance program in which the program is assessed by an independent assessor every five years, who evaluates the compliance with the Charter, standards and code of ethics, efficiency and effectiveness of internal audit functions to fulfil stakeholders' needs.
9. The internal audit department sets annual internal audit plans and undertakes the audit activities as it has been planned. a. The annual internal audit plan takes a risk-based approach. b. The annual internal audit plan is communicated to the audit committee to obtain recommendations. c. The audit plan has to be approved by the CEO and communicated to top management. d. The accomplishment over the targets is in the annual audit plan.
10. The internal auditors report to the CEO and the audit committee. a. The QAR's report has also to be delivered to the audit committee.
11. The internal auditors give recommendations on the business strategy of the company. a. The internal auditors evaluate whether goals of the programs and their operational activities are in accordance with organisation's goals.
12. The internal auditors monitor the follow up of internal and external audit recommendations. a. The internal audit unit has guidelines for monitoring the following up of the internal and external audit recommendations. b. The internal auditors record the results of monitoring activities.

6.2.1.2.2. Compromise Strategic Response to the Decree of Ministry of SOE

The second strategy of compromise was used for three items of the Decree of Ministry of SOE as presented in table 6.6. From interviews as presented in chapter 5, it was found that the auditors only partly implemented responses to these three items.

Table 6.6. Items responded to using Compromise strategy and Pacify tactic

The Decree of Ministry of SOE
1. The internal audit unit must have audit guidelines, SOP and supervisory roles in the internal audit unit, and undertaking quality assurance program. a. The head of internal audit unit sets the policy and procedures as an activity's guidelines for the internal auditor. Such policy and procedures should fit with the structure of the internal audit unit, its size, and also complexity of the business activities of the company. b. The head of internal audit carries out a quality assurance program which covers all aspects of internal audit activities.
2. The internal audit functions contribute to corporate governance process, risk management and internal control improvement.
3. The qualities of internal auditors are appropriate to perform internal audit activities. a. The head of internal audit has capabilities that qualified as internal auditors that certified by the professional association (Certified Internal Auditor / Qualified Internal Auditor). b. There is continual professional development program for internal auditors which aims to maintain their professional certification and provide education support for them.

In relation to the first item part a) most of the requirements had been done. However, the interview revealed that there was no Standard Operating Procedures (SOP) for CSR audit. In line with the interview, the QAR report 2011 also indicated that the audit practiced has been a risk-based audit, while the existing SOP did not up-date to a risk-based audit. Therefore, the existing SOPs were recommended to be up-dated. From the documentation, it was also found that the current SOPs sighted have not been up-dated to satisfy the recommendation. This practice demonstrates that the internal audit unit is using the compromise strategy and pacify tactic, which was indicated by Oliver (1991,p 154) as to "…conform to at least the minimum standard…" If the investigation was limited to looking at the Audit Charter it would have been concluded that the unit was fully compliant with the requirement. Nevertheless, when it is followed in the manner suggested by Fogarty (1996), it is found that not all the requirements are complied with.

Item 1 part b) of the regulation requires the unit to undertake Quality Assurance Reviews (QAR). There are three reviews that should be made. Firstly, an evaluation is to be made on supervision from the stage of audit planning to monitoring the audit recommendations. Secondly, an internal quality assurance review, which is a review of audit activities conducted by a unit external to the internal audit unit, and thirdly external review to be made by parties external to the company. The interviews indicated however, that there was no internal quality assurance review performed of the audit activities. When the head of the internal audit unit was questioned, no reason was given on why the audit unit did not undertake the internal review. This finding is in line with the report of an external reviewer in 2011, which stated that the internal quality assessment has not been fully implemented. Again, this finding indicated the usage of the pacify tactic in response to the pressure. This analysis contributes to the area of institutional theory as previous studies did not investigate this type of situation (Al-Twaijry *et al.*, 2003), Arena *et al.* (2006), Arena and Azzone (2007), and Mihret *et al.* (2012).

The second item of the regulation requires the auditors to contribute to improve the corporate governance process, risk management and internal control. The contribution of the internal audit unit to risk management is indicated by implementing a risk-based audit as documented in the Audit Plan 2014 as well as stated in the interviews. In relation to the contribution to internal control and corporate governance, the interview and the SOPs revealed that the internal audit unit performed audit on Internal Control over Financial Reporting (ICoFR). However, before the audit report is sent to the audit committee, it is screened by management who may omit issues that sensitive to the governance function. This practice indicated that the auditors contribute at the surface by undertaking risk-based audits as well as audits on ICoFR, however,

interference of management on the report will reduce the quality of the assessment of risk management that is communicated to the audit committee. In addition, the interviews also reveal further violations of the regulation conducted by the unit of CSR management that was left to happened by the auditors. The violations were related to the execution of CSR programs. This indicates that the contribution of the internal audit unit is not maximum, only partial. Therefore, it could be said that to this case, the unit responded partially as described by Pacify tactic.

The third item part a) requires the head of internal audit to be qualified as an internal auditor and certified by the professional association. There was no such requirement presented in the Charter. The study investigated this matter through documentation by looking at a Good Corporate Governance (GCG) report 2012, issued by the BPKP indicating that the head of the unit was undertaking a course for the preparation of the Certified Internal Auditor (CIA) examination. In an interview it was mentioned that the head of the unit did attempt the Certified Internal Auditor (CIA) examination, but has not yet passed the exam. Although the unit has not fulfilled the requirement of this regulation, nevertheless it has made an effort to do so. This means the audit unit has responded partly in line with the legislative expectation as indicated by pacify tactic. This study presents another example of the use of the pacify tactic in an attempt to respond to the pressure as suggested by Fogarty (1996). Fogarty (1996) emphasises the distinction between the formal organisational structure demonstrated to the external environment they should accomplish and actual organisational practice.

Regarding the third item part b) as indicated in the interviews, the management did not allow audit staff to attend a seminar organised by FKSPI, an association of internal auditors of SOEs by saying that it was useless. Again this indicates the unit is

partly in line with the legislative expectation, and therefore it could be said to respond to the pressure by using the compromise strategy and pacify tactic.

6.2.1.2.3. Avoidance Strategic Response to the Decree of Ministry of SOE

The third strategy of avoidance is used for six items of the Decree of Ministry of SOE as presented in table 6.7. The interviews as presented in chapter 5 discovered that the unit employed the avoidance strategic response for six items of the Decree of Ministry of SOE.

Table 6.7. Items responded to using Avoidance strategy and Conceal tactic

The Decree of Ministry of SOE
1. The Internal Audit Charter has to contain: a. Consideration of using the Professional Standards of Internal Audit issued by Indonesian Consortium of Internal Auditor or the International Professional Practices Framework of the IIA. b. Explanation of the position of the internal audit unit in an organisation, authorities of internal audit function which includes having access to all recording, people and assets of company, and also scope of the internal audit function.
2. Position of the internal audit unit is directly under the CEO in the organisational structure.
3. The numbers of internal auditors are appropriate to conducting the internal audit activities.
4. The internal audit recommendations can be applied and improve the operational activity.
5. The internal auditors monitor the following up of internal and external audit recommendations and report the monitoring results to the CEO and the audit committee.
6. The head of internal audit has direct access to report to the audit committee.

The table 6.7 demonstrates that the six items were responded to by the unit using the avoidance strategy and concealment tactic. Considering the first item part a) and the second item, it was found that since the unit is under top management, the interference of management in providing the audit report means the essence of the first item about independence cannot be fulfilled. However, interviewees commented that this is the consequence of being under top management. Similarly, it was also argued that recommendations concerning item one part b) about the authority of the auditor, cannot be fully implemented because the unit is under the top management. Item three has also been discussed in the interviews and the use of concealment tactic was indicated in that the unit will use a matrix strategy by allowing each bureau to use staff from other

bureaus to undertake the audit. However, it was also clear that each bureau staff member with a specific specialty will not be effective in a different audit capacity.

For item number four, the conceal tactic was illustrated by a case of an audit report in which the auditee did not respond to the recommendation. When asked about this matter, the auditor mentioned that the auditee did not respond to the recommendation because it was related to management involvement. Item number five requires the auditors to monitor the follow up of audit recommendations. In interviews it was found that there were some cases in which the auditors faced difficulty in monitoring the follow up of the audit recommendations. It was mentioned that the auditee ignored the recommendations, as the auditee was protected by the middle and top management. The conceal tactic used in this response is based on the protection of the auditee by powerful individuals in the hierarchy, which made the audit unit unable to respond fully to the requirement. Finally, item six which allows the auditor to have direct access to the audit committee was also controlled by management by limiting the communication between auditors and the audit committee to a scheduled meeting every three months. This situation again indicated using the conceal tactic to respond to institutional pressure.

6.2.1.3 The Supreme Financial Audit of Indonesian Government

The Indonesian Constitution 1945 provides that the Supreme Financial Audit (BPK) is an external auditor of financial matters to audit all government units and SOEs. This institution is responsible to the House of Representatives of the Republic of Indonesia. The Law No. 15 of 2006 gives authority to BPK to audit SOEs. In addition, verse 20 of the Law No. 15, 2004 requires that the auditee (SOEs) must respond to the audit recommendations issued by BPK. Therefore, any audit recommendation issued by BPK becomes a pressure on the SOE to comply with. In relation to the response of the

audit unit to this requirement, the study investigates the practice of internal audit in dealing with the role of BPK to audit the SOEs.

The Audit Charter states that the internal audit unit has to become a counterpart to external auditors and other relevant audit institutions (Audit Charter, no. 2.2.14). Furthermore, the charter also states that the internal audit must comply with rule and regulation, standards and business ethics (Audit Charter, no. 2.2.6). It was found in an interview that the audit unit did not give the internal audit reports to the BPK nor other confidential data and documents. The reason given was that these documents were for internal purposes only. Another argument used to withhold the documents from BPK was hiding behind the status of a public company which has a right to maintain confidential information. The study made further investigations in relation to an audit undertaken by BPK in the SOE through the website of BPK. It was found that the Audit Report of BPK 2012 shows that BPK conducted a special audit on the operations of SOEs including the holding company and all subsidiaries. Audit findings were as follows: 11 cases of internal control system irregularities and 15 cases of other irregularities. For these findings, the BPK issued 24 audit recommendations. BPK then monitored the follow up actions to the recommendations which were recorded in the BPK's Audit Report in 2013. The report stated 17 recommendations were followed up by the company and 7 recommendations were still in progress. This practice clearly indicates that the audit unit used the compromise strategy and pacify tactic by only partially complying with the regulation.

6.2.1.4 The Financial and Development Supervisory Agency

The Decree No 192 of 2014 of the President specifies the duties of the Financial and Development Supervisory Agency (BPKP) as assisting the government in conducting internal oversight towards national financial accountability in government institutions, including at the SOEs. The BPKP is responsible to the President, which means that BPKP is the coordinator of all internal audits of government units as well as SOEs. The Decree further describes the scope of audit activities comprising the setting of national policies on financial accountability in all government institutions, undertaking an audit over financial accountability, providing consulting services on risk management, internal control and good corporate governance. The Minister of SOE through an official letter; SE-14/MBU/2010, instructed the boards of directors and the CEOs of SOEs to assess the GCG implementation every two years using BPKP as independent assessors.

In responding to this pressure, the internal audit unit under study accommodates the requirement by including it in the Audit Charter and stating the unit has to assist BPKP as a counterparty by providing relevant data to evaluate the implementation of GCG. In the interviews it was mentioned that the audit unit assisted and provided data needed by BPKP which evaluated the implementation of GCG regularly. This practice was also confirmed by the Assessment Report of GCG Implementation in 2012 issued by BPKP. The report did not mention any objection about the role of the internal audit unit. This indicated that the internal audit did assist BPKP and provide relevant data to undertake the GCG evaluation. Therefore, it could be said that the unit under study used the acquiescence strategy and comply tactic to respond to the pressure from BPKP which was stated by Oliver (1991) to be “conscious obedience to or incorporation of values, norms, or institutional requirements”.

6.2.1.5 The Indonesian Stock Exchange

The Indonesian Stock Exchange (IDX) is an institution under Bapepam-LK/OJK that is responsible for carrying out trading of securities in Indonesia. This institution was formed by a merger between the former Jakarta Stock Exchange and Surabaya Stock Exchange. One of the regulations of the IDX that is related to role of internal auditor is the regulation No Kep-306/BEJ/07-2004 that sets requirements for companies to provide an audited annual report and interim report to the public.

In response to this requirement, the internal audit unit under study incorporated this requirement in the Audit Charter. It is stated in the Charter that the internal auditor should regularly undertake analytical reviews on the financial statements of the company. As regards to the implementation of the Charter in practice, it was mentioned in interviews that the auditors undertook analytical review over the financial statements before sending the financial report to the IDX. These interview comments were also supported by the Annual Audit Plan in 2014 which set the review activities to be conducted three times in April, July and October 2014. Therefore it can be said that the audit unit responded to the pressure by using the acquiescence strategy and comply tactic.

6.2.2. Pressure from Informal Structure

Having discussed the pressure from formal sources, there is a need to see the pressure that may come from informal sources. The informal sources of pressure may come from outside organisations on which the institution relies administratively and culturally and those expected by society (DiMaggio and Powell, 1983; 1991). This study uses four sources of pressure prescribed in previous chapters: the Institute of Internal Auditors (IIA), the Sarbanes-Oxley Act 2002 (SOX), the Committee of

Sponsoring Organisations (COSO), and International Organisation for Standardisation (ISO) 26000.

6.2.2.1. Expectation of the Institute of Internal Auditor (IIA) / Indonesian Professional Bodies

The Institute of Internal Auditors (IIA) is an international association of internal audit professionals which was established in the US in 1941 with the aim of assisting auditors in providing high quality audit practice. The IIA issues the International Professional Practices Framework (IPPF). The framework consists of two guidance sets: mandatory and strongly recommended guidance. Mandatory guidance encompasses three elements: the Definition of Internal Auditing, the Code of Ethics, and the International Standards for the Professional Practice of Internal Auditing (Standards). The strongly recommended guidance contains three components; Position Papers, Practice Advisories and Practice Guides. The pressure from IIA is supported by the Consortium of Internal Audit Profession Organisations in Indonesia that has members from various associations such as the IIA Indonesian Chapter, FKSPI an association of internal auditors of SOEs, the Foundation of Internal Audit Education (YPIA), the Certification Boards of Qualified Internal Auditors (DSQIA), and Association of Indonesian Internal Auditors (PAII). All these bodies collaborated to issue an internal audit professional standard called SPAI that covers Internal Audit Definition, the Code of Ethics, the Professional Standards of Internal Audit and the Practice Advisories. This standard is mainly adopted from the IIA’s internal audit standard. The SPAI standard applies pressure by saying that it is compulsory to be followed by internal auditors. However, as a professional body it does not have a formal rule or regulation to oblige the implementation of the standards.

The response of the audit unit toward this pressure was traced to the Internal Audit Charter. It is found that the Charter accommodated this requirement by using SPAI and the IPPF as reference to carry out internal audit practice. Although it was mentioned in the interviews that the requirement of the standard has been applied, it was clearly indicated in previous cases that some aspects have not been fully complied with. For example, the independence of internal auditors was interfered with by management, and the internal Quality Assurance Review (QAR) has not been implemented. This situation indicated that the internal audit unit responded to the pressure using the compromise strategy and pacify tactic as characterised by "partial conformity with the expectations of one or more constituents" (Oliver, 1991, p. 153)

6.2.2.2. Expectation of the Sarbanes Oxley Act (SOX Act) 2002

The Sarbanes Oxley Act (SOX 2002) was issued by the US Congress in 2002 as a response to the collapse of large corporations in the US in 2001-2002. This Act sets a number of requirements for corporate responsibilities, particularly for financial reports (section 302) and management assessment of internal controls (section 404). The SOX 2002 requires a more effective system of internal controls over financial reporting (ICoFR) (Hass *et al.*, 2006). The SOX 2002 was published in order to meet the public demand for better corporate governance in the US. The implementation and assessment of the ICoFR as one of key aspects of good corporate governance (GCG) spread globally through the requirement of NYSE for all companies listed in the NYSE to implement GCG principles. The legislation also indirectly affects internal audit activities by extending its scope of work, especially in ensuring the effectiveness of ICoFR.

The expectation of GCG implementation also spread to Indonesia. There are two institutions in Indonesia in this regard. The ministry of SOE issued a GCG handbook for

all SOEs that operate in Indonesia. Another independent institution called the National Committee of Governance Policy (KNKG) issued a GCG handbook for all sectors including non SOEs. Since the KNKG is an independent institution, the requirements in the handbook will be complied with voluntarily. The requirement of the KNKG handbook reflects the expectations of Indonesian society towards public and private sectors in having ethical awareness in conducting business. The guidance also recommends the companies establish the internal audit unit to assist top management in maintaining the effectiveness of the risk control process.

The company under study is a public SOE that is only listed on the Indonesian Stock Exchange (IDX). Though it is not listed in the US stock market, the internal audit unit considers the GCG requirement as pressure from public expectations both domestic and international. In response to this pressure, the internal audit unit has adapted the requirement in the Audit Charter. It is stated in the Charter that the internal audit should ensure that the GCG has been implemented. The Charter also specifically mentioned the role of an internal auditor is to ensure that the internal control of the company as a whole is effective where the ICoFR is a part of the internal control systems. As required by Fogarty (1996), to investigate the implementation of the response in practice the study follows it through interviews and documentation. The interview revealed that the company under study was audited by a public accounting firm that was affiliated with an international public accounting firm which issues recommendations to establish the ICoFR system and suggests the internal audit review the ICoFR system regularly. From documentation, it was found that the Annual Internal Audit Plan 2014 allocated the internal audit activities to review the implementation of ICoFR.

This situation demonstrates that the internal audit unit used the acquiescence strategy and imitate tactic toward the SOX expectation in which DiMaggio and Powel,

1983 (cited in Oliver. 1991, p.152) gave an example of Imitate tactic as "…imitation of successful organizations and the acceptance of advice from consulting firms or professional associations."

6.2.2.3. Expectation of the Committee of Sponsoring Organisations (COSO)

COSO is an independent body, also known as the Treadway Commission, that was founded in the US in 1985 in response to increasing business failures related to failure of the role of external audits in the US. The commission recommends all top management of public companies to maintain appropriate internal controls and effective internal audit functions to prevent and detect fraudulent financial reporting. In 1992, COSO issued a framework named Internal Control-Integrated Framework that comprises five components: control environment, risk assessment, control activities, information and communication, and monitoring. The critical role of the internal audit function is in the monitoring component in which the internal auditor should ensure internal control objectives are achieved. These include: effectiveness and efficiency of operations, reliability of financial reporting and compliance with laws and regulations.

Tracing this requirement to the Audit Charter, it was found that there is no adoption of COSO requirement in the Audit Charter. However, the interviews revealed that the internal audit unit used the COSO framework as guidance in their audit activities. From documentation, it was found that Annual Audit Plan 2014 presented a plan for a consultant to provide a training course on COSO for internal auditors. The study also undertook observation by attending the training course which was organised by a consulting firm. In that event, the trainer provided information about the latest requirements of COSO. This finding indicated that the internal audit unit used Acquiescence strategy and Imitate tactic to respond to the pressure from COSO.

6.2.2.4. Expectations of Society

The International Organization for Standardization (ISO) 26000 provides guidance for organisations to carry out their business activities in a socially responsible way. For this purpose, the companies are recommended to perform their actions in an ethical and transparent way that contributes to the health and welfare of society. In this case, the society means people or groups who are affected by the actions of organisations and they also have the ability to affect the entity (ISO 26000, 2010, clause 2.20- 2.21). ISO 26000 provides a number of indicators for ethical behaviour. One of these is “[a]sk yourself: would you be comfortable if your actions were to become public knowledge?” (2010, clause 2.7). Undertaking CSR programs is a critical approach to maintaining a beneficial relationship between the companies and society as well as the environment in which they operate. Therefore, it could be said that society's expectations are represented by the ISO 26000.

Since Indonesia is a member of ISO, ISO 26000 is adopted by the National Standardisation Agency of Indonesia (BSN) and is called SNI ISO 26000. Both international and domestic standards of ISO 26000 are used as guidance in conducting CSR programs by the SOE studied. According to the company policy, the implementation of CSR programs covers the area surrounding the factories of the SOE studied. The CSR programs comprise diverse programs such as Partnership Program (PK) and the Environment Development Program (BL).

In terms of pressure from public expectations as represented by ISO standards, the response of the audit unit to this pressure is by stating in the Audit Charter verse 2.2.6 that it requires the internal auditors to ensure the company comply with regulations, law, standards, and business ethics. However, the interviews demonstrate that there were no standard operating procedures (SOP) that should be followed by the auditors when

assessing the operation of the CSR program. The interviews also uncovered some irregularity performed by the CSR unit and reported in the audit report but there was no feedback received from CEO so follow up of this matter was impossible. The documentation of audit reports also supported this situation, but as a confidential document, it cannot be further explained.

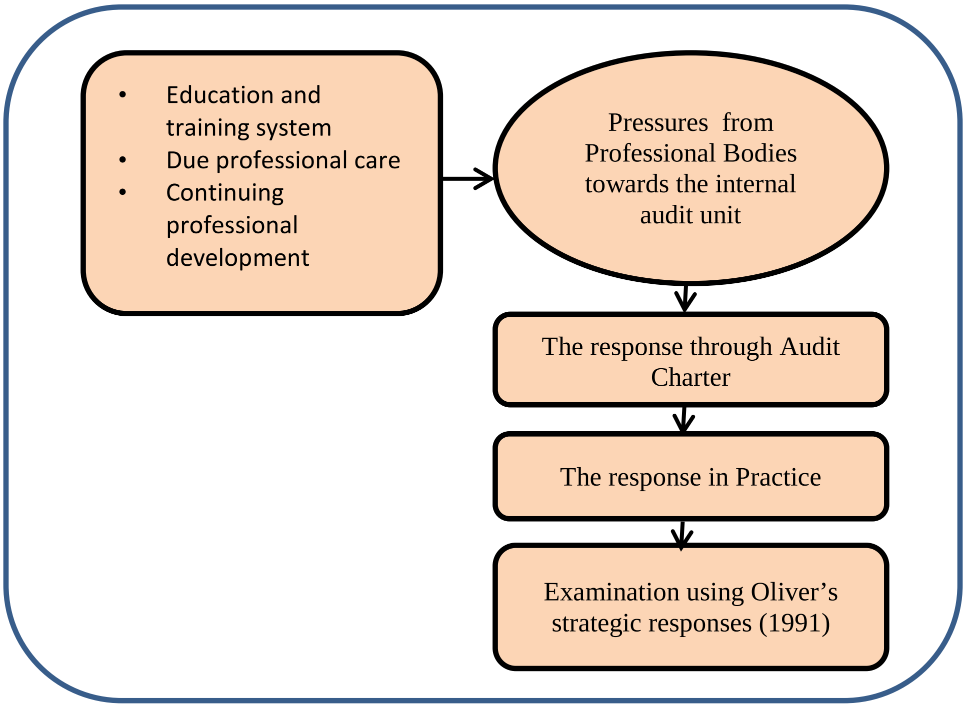
The response to this public pressure demonstrates that the auditors did not fully comply with the business ethics and standards mentioned in the Charter. Therefore, it can be said that the internal audit unit used the compromise strategy and pacify tactic to respond to the expectation of ISO standards.

6.3. Normative Isomorphism and the Practice of Internal Auditing

Normative isomorphism is based on the idea that organisational change stems primarily from professionalism and sustainable education (DiMaggio & Powell 1983). According to DiMaggio & Powell (1983), the professionalisation comprises two important aspects of isomorphism sources, namely formal education as well as professional networks that share knowledge and technologies. DiMaggio and Powell (1991) further claim that normative pressures are transferred via education, professional standards, and inter-organisational networks.

In the case of the SOE under study, the investigation of how and what actions were taken by the internal audit unit in response to normative pressure is presented in figure 6.2., and the normative pressure refers to the professionalism and sustainable education are presented in table 6.8.

Figure 6.2. Normative Pressures towards Internal Audit Practice



The normative pressures are derived from education requirements and also from various relevant professional bodies. They are the Institute of Internal Auditors (IIA) and the Indonesian Consortium of Internal Audit Professional Organisations. The consortium comprises five members of professional bodies. They are: the Indonesian chapter of the IIA, Communication Forum of SOE's Internal Auditors (FKSPI), the Foundation of Internal Audit Education (YPIA), the Certification Boards of Qualified Internal Auditors (DSQIA), and the Association of Indonesian Internal Auditors (PAII). Both IIA as international bodies and Indonesian professional bodies issued Internal Audit Standards. The standard issued by the Indonesian Professional bodies basically is an adoption of the international standard issued by the IIA. These professional bodies essentially aim to promote internal audit guidance and professional standards as well as foster global adoption of internal audit best practices (http://www.theiia.org).

Table 6.8. The Responses to Normative Institutional Pressures

Main Sources of Normative Pressures
1. Education and training system – The IIA suggests the internal auditors to possess sufficient knowledge, skills, and other competencies. – The IIA encourages the internal auditor to possess appropriate certifications. 2. The IIA recommends the auditors to undertake their duties with due professional care. 3. The IIA encourages the internal auditors to enhance their competence through continuing professional development.

Tracing the response of this particular pressure into the Audit Charter, it was found that the internal audit unit responded to the normative pressures by presenting its requirement in the Internal Audit Charter. This means that the unit investigated complies officially with all items suggested by the professional bodies. Further investigation sought to find out the implementation of the audit charter in practice as suggested by Fogarty (1996).

The knowledge, skills and competencies of the internal auditors required in the Audit Charter is rather detailed. The Charter describes the competencies as including capabilities in internal auditing, information technology, accounting (limited to auditors who audit financial aspects), good business practices, and knowledge to identify fraud. Another requirement is communication skills, both verbal and written. In interviews it was found that there was no problem with the requirement for verbal communication skills used by the auditors to communicate to the auditee. However, many of the auditors have problems with written communication skills, particularly in relation to preparation of the audit report.

The result from interviews indicated that most of the auditors have a lack of knowledge and experience in internal auditing. It was mentioned that many of the auditors were recruited from a working unit that did not require internal auditing skills or background. They were recruited to obtain staff with a sound understanding of the

operation of their former unit. So they have more understanding of business operations and it was assumed they would have more capability to assess business risk and control, which is relevant to risk-based auditing. Therefore, the auditors have various educational backgrounds other than accounting, economics and auditing such as: civil engineering, chemistry, and information technology.

The interviews also revealed that the internal audit unit under study attempted to comply with pressure by providing internal and external training to increase skills and competencies that are required by professional certification. In line with findings from interviews, the documentation of the Annual Audit Plan 2014 presented various provisions for training. The training covered many areas such as auditing, risk management and information technology, as well as training for professional certification such as Professional Internal Auditor (PIA), Qualified Internal Auditor (QIA), Certified Risk Management Professional (CRMP), and Certified Information System Auditor (CISA). Regarding professional certification, it was found from interviews that many auditors faced difficulty in obtaining the professional certificates and even some of them took many years to get it.

Hence the response of the internal audit unit regarding proficiency is not perfect, particularly as most of auditors recruited have no knowledge or experience in internal auditing, which means in turn that the audit unit only partially complies with the pressure. Nevertheless, the unit had shown its intention to comply with the pressure but may take time for full compliance. It can be said therefore, the response made by the audit unit is the compromise strategy and pacify tactic. The finding of this study contributes to knowledge on institutional theory that the compromise strategy and pacify tactic used by the unit was attempting to pursue the requirement, by providing

internal and external training. However, some limitations still occur to full compliance as it is part of the nature of the unit under investigation.

The second pressure is about requirements for internal auditors to undertake their duty with due professional care. The Internal Audit Standard issued by IIA (2013, p. 20) on this matter stated that “Internal Auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor.” This pressure was adopted in the Audit Charter number 3.3.2 in point h) and in more detail in i). In the interviews it was mentioned that the execution of the internal audit function has to comply with regulations and standards. The compliance in this regard should include compliance with the Audit Charter with regard to carrying out the task with due professional care. Considering the lack of knowledge, skills and competencies of the internal auditors as discussed previously, it is hard to say that the internal auditors are able to implement this requirement in practice. Although the response of the internal audit unit could not fully comply with the charter, adopting the standard into the Audit Charter and attempting to provide training and professional certification indicates the unit used the compromise strategy with pacify tactic.

The third pressure is sourced from the proposition to undertake continuing professional development, which has been adopted in the audit charter. The charter describes it as consisting of numerous activities such as attending training, seminars and other events to gain understanding on the latest development of standards, procedures, audit techniques and business environment. The interviews demonstrated that all auditors wanted to improve and maintain their competency by attending international and local seminars as well as conferences. However, as discussed earlier, not all auditors had a chance to attend those events, particularly for international seminars or conferences. Only selected auditors were chosen by the head of audit unit or the head of

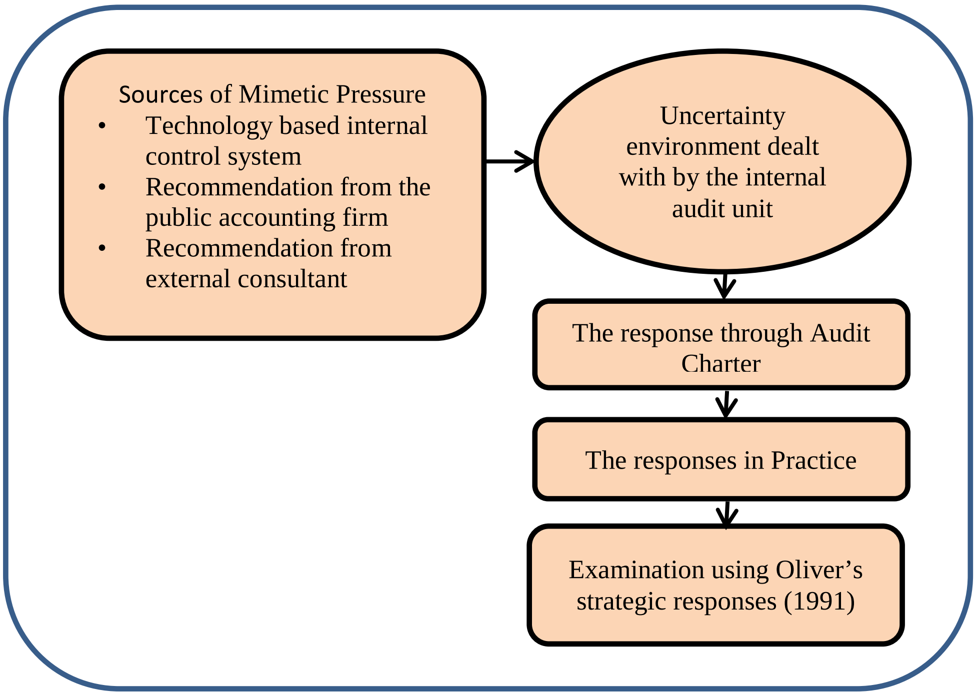
audit bureaus to attend those events. Although it is not mentioned in the charter that membership of professional bodies is part of continuous professional development, as suggested by IIA, in practice some of the auditors are members of the bodies and the membership fees are paid by the company.

The condition above illustrated that the audit unit has responded positively to IIA encouragement. However, the unit may not be able to fully satisfy the pressure, as indicated by not all the auditors being able to be a member of a professional body or attending seminars or conferences domestically and/or internationally. This situation demonstrates that the internal audit unit used the compromise strategy and pacify tactic to respond to pressure.

6.4. Mimetic Isomorphism and the Practice of Internal Auditing

Mimetic isomorphism is when organisations respond to uncertainty with imitation (DiMaggio and Powell, 1983). The uncertainty may arise from poor understanding of organisational technologies, goal ambiguity and uncertain on environmental expectations. The mimetic efforts may be followed intentionally or unintentionally. The desire to copy intentionally may be based on observation of a successful organisation or suggestions from a consulting firm or industry trade association (DiMaggio and Powell, 1983). In turn, the unintentional desire to copy may arise through transfer or turnover of employees that bring their previous knowledge or practice (DiMaggio and Powell, 1983). The rationality to examine how the unit responded to the pressure is presented in figure 6.3.

Figure 6.3. Mimetic Pressures towards Internal Auditing Practice



The result from interviews stated that the internal auditor perceived that the activities of the company are complex, and therefore need a strong technological base and internal control systems. At this stage the internal auditor was unsure how to develop proper internal control systems. In interviews it was mentioned that a team from the company went to visit a successful SOE in Bandung which is listed on the NYSE. The team also went to visit some successful companies overseas. In addition, it was mentioned that the company used a public accounting firm that undertook assessment on the ICoFR and a consultant firm to assess the implementation of COSO guidance. From those interviews it could be said that the internal audit unit may receive mimetic pressure from three grounds as presented in table 6.9.

Table 6.9. The Responses to Mimetic Institutional Pressures

Main Sources of Mimetic Forces
1. A formal visitation to other SOE and overseas corporations, which are perceived to be more successful, in order to learn their technology-based internal control system. This learning visit was in order to build an in-house control system with a technology basis.
2. Recommendation from the public accounting firm to implement and audit the Internal Control over Financial Reporting (ICoFR) as one of the cores of SOX 2002
3. Recommendation from consultant to employ internal control system - integrated framework issued by COSO as guidance in assessing the effectiveness of internal control.

An investigation of the Audit Charter, found no statement in the charter that clearly links the content of the charter with this pressure. Nevertheless, it does not preclude the possibility that some of items in the charter are the results of imitating a successful company visited, or are recommendations from the public accounting or the consulting firm. In relation to the first pressure listed above, an interview was found to support that possibility. The head of the unit mentioned that the visit was followed up by developing a technology-based internal control system assisted by a consulting firm and involving information technology personnel of the company. Additionally, the head of the unit also mentioned his intention to be similar to the visited SOE in the near future. Therefore, it could be said that the internal audit unit under study uses the acquiescence strategy and imitate tactic to respond to the mimetic pressure experienced by the unit. In this case, the internal audit unit undertakes the imitate response to the mimetic pressure by consciously adopting a technology-based internal control system.

Regarding the second item, the interviews revealed that this pressure stemmed from the recommendation of the international affiliation of public accounting firm. The Charter did not mention that the internal auditors have to follow up the external auditor's recommendations. However, it was described in the Charter that the internal auditors are the counterparty of external auditors in conducting the audit activities, and may exchange their management letters of the audit report. This management letter

contains all deficiencies found in the audit process, including the weaknesses of internal control systems, which need to be improved. In interviews, it was mentioned that the internal audit unit responded to the recommendation by implementing ICoFR and creating accompanying guidelines. The analysis on this matter demonstrates that the internal audit unit used the acquiescence strategy and conscious imitate tactic. This tactic is clearly described by DiMaggio and Powel (1983, cited in Oliver, 1991, p.152) as "…the acceptance of advice from consulting firms or professional organizations."

As described in the audit charter the internal audit unit may use a consulting firm if necessary. This matter was further investigated by the study through interviews as part of the data collection technique. The interviews showed that the internal audit unit hired a consulting firm to assess COSO implementation and propose recommendations. From observations, it was found that the influence of the consulting firm was also through provision of training and seminars using consultant and guest speakers to update knowledge on COSO requirements. Finally, it was found in the annual report 2014 that the company had implemented an Internal Control-Integrated Framework issued by COSO.

The findings above indicate that that the internal audit unit responded to mimetic pressure by implementing an Internal Control-Integrated Framework issued by COSO as recommended by the consulting firm. Therefore, it can be said that the response used by the unit is the acquiescence strategy and conscious Imitate tactic. Since most of the auditors were recruited from internal units within the company, the unintentional desire to copy that arose through transfer or turnover of employee is unlikely to occur.

6.5. Summary

The research questions of the study are to investigate the effect the institutional pressures have on the practice of an internal audit unit of a public SOE in Indonesia. This chapter presents some analysis of the response of this internal audit unit to institutional pressures that arose from various sources. The study considers three types of pressures developed by DiMaggio and Powell (1983, 1991) that comprise coercive, normative and mimetic pressure. In relation to the response, the study uses five ranges of strategies and tactics developed by Oliver (1996) to determine the type of responses undertaken by the audit unit: acquiescence, compromise, avoidance, defiance, and manipulation strategies.

Since the internal audit unit under investigation is a public SOE in which the majority interest is owned by the government of Indonesia, it is considered that pressures may arise from sources which are different to those in a fully private company. In terms of coercive pressures, there are two categories of pressure which arise: formal and informal pressures. Formal pressures are the pressures from government mandates, regulations and the standard operating pressures as indicated by the following regulations issued by Bapepam/OJK, Ministry of SOE, BPK, BPKP, and IDX. The informal pressures are the pressures from public expectations, that is, from the IIA/Indonesian internal auditor association, SOX 2002, COSO, and society.

The first level of investigation indicates that the internal audit unit responded to coercive pressures by accommodating all the requirements in the internal audit charter, except for five aspects. First, the Audit Charter did not state that the head of internal audit unit must have professional certification. Second, the requirement that the number of internal auditors must be appropriate with the business complexity of company was not present in the Charter. Third, the COSO requirement was not adopted in the Audit

Charter. Fourth, learning technology-based internal control systems from other successful SOEs was not included in the Charter. Finally, the implementation of an ICoFR review based on the public accounting firm recommendations as well as the updating of COSO guideline based on the consulting firm were not present in the Charter.

The second stage of investigation indicates that there are various responses performed by the audit unit. In terms of formal coercive pressures, the responses to the pressure from Bapepam/OJK consist of four different strategies and tactics: the acquiescence strategy with comply tactic, the compromise strategy with pacify tactic, the avoidance strategy with conceal tactic and the defiance strategy with dismiss tactic. For the regulations issued by Ministry of SOE, the audit unit responds to the pressures by undertaking the acquiescence strategy with comply tactic, the compromise strategy with pacify tactic, and the avoidance strategy with conceal tactic. In terms of the pressures from BPK regulation, the internal audit unit undertakes the compromise strategy and pacify tactic, while for the BPKP regulation, the acquiescence strategy and comply tactic are practiced. The IDX regulations are responded to by the audit unit using the acquiescence strategy and comply tactic. Furthermore, the informal coercive pressures are responded to differently by the audit unit. They consist of the compromise strategy and pacify tactic for response to the expectations of IIA/the Indonesian professional bodies, and conducting the acquiescence strategy and imitate tactic for SOX 2002 expectations. Regarding the expectations of COSO, the unit responded by using the acquiescence strategy and imitate tactic; while the expectation of the society is responded to by undertaking the compromise strategy and pacify tactic.

The normative pressures arising from professional bodies such as the IIA/Indonesian internal auditor association encompass education and training systems,

due professional care and continuing professional development. In terms of normative pressures, the audit unit uses the compromise strategy and pacify tactic to respond to the pressures. In turn, mimetic pressures stem from the technology-based internal control system, and recommendations from a public accounting firm as well as an external consultant. The response of the unit to mimetic pressure was indicated by using the acquiescence strategy and imitate tactic.

It could be argued that the findings confirm that the three institutional pressures do affect the practice of internal audit function. The adoption of the requirements in the internal audit charter indicated the effect of the pressure on the operation of the internal audit unit. Furthermore, the practice of the internal audit function was mostly in line with the Audit Charter.

The findings contribute to the domain of internal audit and institutional theory, particularly in regard to the organisational responses to institutional pressures suggested by Oliver (1991). This study also provides additional contributions to previous studies (Al-Twaijry *et al.*, 2003; Arena *et al.*, 2006; Arena and Azzone, 2007; Mihret *et al.*, 2012) since these were only undertaken at a single level of investigation, while this study conducted two levels of examination as suggested by Fogarty (1996). Also, this study examined formal and informal coercive pressures on the internal audit practice and its responses, whereas prior studies only focused on formal coercive pressures on the practice of internal audit and its responses. Therefore, this study draws a comprehensive picture of internal audit as it involves all levels of auditors in the organisational structure of the internal audit unit, while previous studies (Al-Twaijry *et al.*, 2003; Arena *et al.*, 2006; Arena and Azzone, 2007; Mihret *et al.*, 2012) only involve the highest level of auditor as the participants.

This study has a different institutional context to prior studies (Al-Twaijry *et al.*, 2003; Arena and Azzone, 2007, and Mihret *et al.*, 2012). The democratic political system in Indonesia creates the unique context of an institutional environment in Indonesia. The colonial era may affect the political system in Indonesia by creating massive regulations to control government institutions such as Bapepam/OJK, the Ministry of SOE, BPK, BPKP, IDX. Since 1991, when the government allowed the SOEs to go public, the country started to establish professional bodies that facilitated and encouraged internal audit standards to be implemented. The development of Indonesian professional bodies of internal audit is indicated by the existence of the Indonesian chapter of the IIA, FKSPI, the Foundation of Internal Audit Education (YPIA), the Certification Boards of Qualified Internal Auditors (DSQIA), and Association of Indonesian Internal Auditors (PAII). Therefore, it can be concluded that the results of investigation provide an understanding that the institutional pressures (coercive, normative and mimetic) influence the practice of the internal audit function of the SOE under study.

Chapter 7
Summary and Conclusion

7.1. Introduction

Internal Audit is an important element in the assurance environment of both public and private sector organisations, a valuable tool and a contributor to effective management of risk associated with the operations of these organisations. It is a particularity important function for State-Owned Enterprises (SOEs) in Indonesia given the fact that a substantial amount of public money is spent in running these organisations to achieve the significant economic contributions they make to the country. However, a series of cases involving corruption and misappropriation of funds in these organisations in recent years has raised doubts about the effectiveness of their audit functions. The lack of research in the internal audit practice in the SOEs in Indonesia, concerns over the effectiveness of internal audit practice and well documented issues with the financial management of SOEs provided the background for this study.

Given the above background, the major aim of this study is to investigate the internal audit practice of a SOE in Indonesia through the lens of institutional theory and to examine how coercive, normative and mimetic pressures affect the internal auditing practice of the enterprise. It also considers the coercive pressures that arise from both formal and informal sources. The formal sources considered are the legal and standards requirements imposed by public institutions such as the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) or Indonesia Financial Services Authority (OJK), the Ministry of State-Owned Enterprise, the Supreme Financial Audit of Indonesian Government (BPK), the Financial and Development Supervisory Agency (BPKP) and the Indonesian Stock Exchange (IDX). The informal sources considered

are the public pressures arising from the Institute of Internal Auditors (IIA), the Sarbanes Oxley Act 2002 (SOX), the Committee of Sponsoring Organisations (COSO), and the International Organisation for Standardisation (ISO) 26000. Accordingly, this study aims to answer the following research question.

> How does the practice of internal auditing in Indonesian SOE react to the coercive, normative and mimetic pressures coming from the environment?

In summary, in attempting to answer the research question, this study first provides a research background and highlights the significance, aims, scope, and contributions of the study in chapter 1. It then critically reviews prior studies that have examined the internal auditing function (chapter 2) giving an insight into previously identified issues on internal auditing practice in both developed and developing countries. The research design and the methods adopted in examining the underlying issues are then discussed in chapter 3. The historical account of SOEs in Indonesia, together with its legal and institutional framework applicable to internal auditing practice are discussed in chapter 4, placing this study in the Indonesian context. On the basis of data obtained from interviews in a public SOE, chapter 5 describes the internal audit practice of the Indonesian public SOE chosen for the case study. Using the information presented in chapter 5 and the theoretical lens provided by the institutional theory, chapter 6 then examines the responses of the chosen SOE to institutional pressures following two steps approach. In the first-step, the study examines the strategic responses to processes made by the SOE to release the pressure. For this purpose, the changes made by the SOE to the audit charter as a response to instructional pressure are examined using the strategic response framework proposed by Oliver (1991). In the second step, using a method proposed by Fogarty (1996), the study compares the practice described in the audit charter with the practices described by the interviewees to determine whether what is prescribed in the audit charter is actually

being practiced. Finally, this chapter provides findings and conclusions of the study and highlights its contributions, implications and limitations.

7.2. The Findings and conclusions

The review of literature in chapter 2 indicates that studies of internal audit practice in developing countries such as Indonesia using institutional theory are limited. This situation highlights the needs for more research to be undertaken to understand the internal auditing practices in Indonesia, which are largely influenced by the unique social, political and economical characteristics that Indonesia has inherited from its colonial masters. The literature review also reveals a number of areas that are seriously under researched, requiring further investigation. First, there is no prior study examining the internal audit practice of an Indonesian SOE. Second, studies that examined the internal auditing practice were confined to examining formal coercive pressures and neglected informal coercive pressures. Third, prior studies that examined the responses of the internal audit unit towards institutional pressures have primarily used interview and/or survey data for obtaining data and neglected the need to discover such practices through an examination of the Internal Audit Charter. Fourth, prior studies have primarily focused on the experiences and activities conducted by upper management level for their examinations and have largely ignored those of the middle and bottom levels of internal auditors in the internal audit unit.

As presented in chapter four, Indonesia has inherited many distinctive administrative features from practices in a long colonial era. In addition to these influences, the political system has created a massive regulatory framework to control activities of government units. The regulatory system that continually issued regulations governing the practices of business organisations consist of institutions including the Capital Market Regulatory Body and Financial Institution (Bapepam-LK) which was

then replaced by the Indonesia Financial Services Authority (OJK), the Ministry of State-Owned Enterprises, the Supreme Financial Audit of Indonesian Government (BPK), the Financial and Development Supervisory Agency (BPKP) and the Indonesian Stock Exchange (IDX). In addition, the Indonesian constitution also provided a legal environment that supported the establishment of professional bodies that facilitate and encourage internal audit standards to be developed and implemented.

The distinct institutional context in Indonesia and the gaps discovered in the literature provided ground for using institutional theory to uncover the internal audit practice of an Indonesian public SOE, which has not been a subject of prior research. The examination was carried out using the institutional theory and primarily investigated the effect of institutional pressures on the internal audit charter, and the extent to which the charter has been put into practice by involving all levels of internal auditors in the internal audit unit. As revealed in the previous chapter, the three institutional pressures - coercive, normative and mimetic - were found to have a significant impact on the internal audit practice of the internal audit unit which was subject of the case study.

As indicated previously, this study investigates the responses to pressure in two stages. The first stage is to investigate how institutional pressure impacted on the internal audit practice in the form of amendments to the audit chapter. The second stage is to investigate whether or not items in audit charter were really put into practice by the internal audit unit of the company under the study. The examination in the first stage revealed that the charter adopted almost all responses that were designed to release institutional pressures. However, in five cases of formal coercive pressures the responses were not adopted by the charter. As a public SOE, formal coercive pressure is mandatory due to the fact that the government has more than 50% of the ownership of

the business entities. The requirements not adopted by the charter are as follows: (1) requirement for the professional certification of the head of internal audit unit, (2) requirement to state the number of internal auditors in the audit charter, (3) requirement to follow the Committee of Sponsoring Organisations (COSO), (4) requirement to establish technology-based internal control systems that are learned from other successful SOEs, and (5) the implementation of Internal Control over Financial Reporting (ICoFR) reviews based on public accounting firm recommendations as well as the updating of COSO guideline application based on the consulting firm's recommendations.

The examination in the second stage was carried out to investigate the extent to which requirements of the internal audit charter are followed. This used data from interviews, relevant internal documentation, and observations. This examination revealed that the internal audit unit has taken various steps to ensure that the requirements of the auditing charter are followed. In terms of formal coercive pressure from Bapepam-LK/OJK, the responses of the audit unit consist of four different strategies and tactics: acquiescence strategy with comply tactic; compromise strategy with pacify tactic; avoidance strategy with conceal tactic; and defiance strategy with dismiss tactic. An acquiescence strategy with comply tactic means that the internal audit unit complies with the Bapepam-LK/OJK regulation consciously (Oliver 1991). As for the rationality behind such a response, two reasons are provided by the interviewees. First, as a state-owned entity, the unit has to comply with government regulation. Second, as a public company, the unit investigated has to comply with Bapepam-LK/OJK's regulation which acts as a stock market regulator.

The study found that the internal audit unit responded to two of the regulations of Bapepam-LK/OJK - duties and responsibilities of internal audit and qualification of

internal auditor - using compromise strategy with pacify tactic. Oliver (1991) defined compromise strategy and pacify tactic as a ‘partial conformity with the expectations of one or more constituents’ (Oliver, 1991, p. 153).

In the case of duties and responsibilities, the pacify tactic was used because of management interference in the preparation of the audit report. In the case of qualification, the pacify tactic was used because of the lack of qualified auditors with auditing knowledge and experience in the unit. This is because the audit unit recruits auditors from other units with no accounting or auditing background. The reason for using an internal recruitment system to recruit auditors from internal divisions is because the audit unit considers that people who have gained knowledge of the business operations in other divisions of the organisation are in a better position to function as auditors than someone hired from outside with auditing knowledge. The audit unit is of the opinion that internally recruited people are able to assess the risk and controls of the business organisation better than people hired from outside and they can obtain the auditing knowledge over time through internal and external training, professional certification and professional development programs.

The avoidance strategy and conceal tactic was also found to be used to respond to four items of Bapepam-LK/OJK regulation. Conceal tactic is associated with the response to disguise the fact that it does not intend to implement the requirement using a rational plan (Oliver, 1991). This tactic was used to avoid recruitment of auditors by assuming that the use of a matrix system is enough to execute the audit plan. The practice of not reporting any issues that implicate top management's involvement with an issue is influenced by the belief that reporting such issues is a futile exercise given the fact that the audit unit is under the management of CEO and his/her approval is required for submitting a report to the audit committee. The limited number of auditors

in the unit has also had an impact on the unit's use of the tactic of refusing to assess all activities in the organisation. In conclusion, it was found that the audit unit is using the avoidance strategy and conceal tactic in relation to issues that implicate top management because of the practical reality of not being able to report such issues to the audit committee directly without the prior approval of the CEO - who would naturally be reluctant to approve a report that implicates top management.

The defiance strategy and dismiss tactic were found to be used by the audit unit in relation to two items of Bapepam-LK/OJK regulations. According to Oliver (1991), the dismiss tactic refers to "ignoring institutional rules and values" (p.156). This was evident by the finding that a high rank official in the internal audit unit was also found to be functioning as a board member of a subsidiary company. This is direct violation of the requirement of Bapepam-LK/OJK regulations. The relatively small size of the subsidiary was found to be the reason for unit's using the dismiss tactic in this instance.

For the regulations issued by the Ministry of SOEs, the audit unit responded to pressures by using various strategies and tactics such as acquiescence strategy with comply tactic, compromise strategy with pacify tactic, and avoidance strategy with conceal tactic. The study found that the audit unit responded to three items of the Decree of Ministry of SOE using compromise strategy and pacify tactic. The reason for using this strategy and tactic is the interference of management in preparing the audit report. Furthermore, the audit unit responded to six items of the Decree of Ministry of SOE by using avoidance strategy and conceal tactic. The use of this strategy and tactic was also found to be due to the interference of management in the preparation of the audit report.

In terms of pressures from BPK regulations, the internal audit unit undertook a compromise strategy and pacify tactic. The response was revealed by the decision of the

internal audit unit to not provide the internal audit reports to BPK. The unit justified this action on the ground that these reports contained confidential data and were prepared for internal managerial purposes only. The unit also sighted the right of a public company to keep confidential and sensitive information out of the public domain as another reason for not releasing these reports to BPK.

The acquiescence strategy and comply tactic was found to be used by the internal audit unit in response to BPKP and IDX regulations. In the case of BPKP regulation, this tactic was evident from the assistance provided by the audit unit to the BPKP in providing data for the assessment of good corporate governance (GCG) which is a compulsory requirement of the Ministry of SOEs. The reason for adopting the comply tactic was that it is incumbent on the company, as an SOE, to provide this assessment to the Ministry of SOE. In the case of IDX regulations, this tactic was evident from the thorough analytical review undertaken by the company of the financial statements of the company three times a year. The reason for adopting a comply tactic was that in order to keep the company listed on IDX, it is necessary to comply with the IDX requirement of providing reliable financial statements.

The study also found that evidence of the audit unit responding to less formal coercive pressures. In this regard, the unit adopted the compromise strategy and pacify tactic to respond to the expectations of the Institute of Internal Auditors (IIA)/the Indonesian internal auditor associations. The response to the professional bodies' recommendations was categorised as pacify tactic as the internal audit unit has not undertaken all of the requirements of the internal audit standards. A number of factors such as the existence of limited number of auditors, lack of audit knowledge, conflict of interest and management interference are considered to be the reasons for this response.

SOX 2002 focused on the implementation of Internal Control over Financial Reporting (ICoFR) as one of the aspects of a good corporate governance process. The internal audit unit adopted an acquiescence strategy and imitate tactic in responding to expectations of the Sarbanes Oxley Act (SOX) 2002. The decision was influenced by the recommendation of a public accounting firm affiliated with international public accounting firm.

Regarding the expectations of the Committee of Sponsoring Organisations (COSO), the unit responded by using acquiescence strategy and imitate tactic. Again, this response was a result of the implementation of one of the recommendations made by the company's consulting firm.

In the case of requirements of ISO 26000, the audit unit adopted a compromise strategy and pacify tactic. Particularly, with regard to the scheme to provide financial aid and soft loans to the local community near the company factory, it appears that the audit unit was undertaking a pacify tactic whereby requirements of ISO 26000 were not followed fully. In fact, there were no Standard Operating Procedures (SOP) for conducting the CSR program. The reason for the activities of the CSR program not coming under the full scrutiny of the audit unit was the involvement of top management in the program and ambiguity over who was running the program. Although top management is largely involved in the design of the CSR program, the audit unit, which is supposed to audit activities of the program, is also involved in implementation of some part of the CSR program.

Normative pressures arising from professional bodies such as the IIA/Indonesian internal auditor association encompass education and training systems, due professional care and continuing professional development. In responding to these normative pressures, the audit unit uses Compromise Strategy and Pacify tactic. In contrast,

Mimetic pressures stem from a technology-based internal control system, and recommendations from a public accounting firm as well as from an external consultant. The response of the unit to Mimetic pressure was to use acquiescence strategy and an imitate tactic.

In conclusion, the investigation of the internal audit practice of a SOE in Indonesia revealed the existence of the three institutional pressures and analysed their impact on the Internal audit practice in SOE in Indonesia. The study also found that the audit unit examined has responded to coercive, normative and memetic pressures through changes to requirements stated in the internal audit charter which was found to have a profound impact on the internal audit practice in the public SOE examined. Furthermore, the practices of the internal audit function were found to be mostly in line with the Audit Charter. The preceding chapter provided a detailed explanation of how coercive, normative and memetic pressures affect the internal audit practice in the case of an Indonesian public SOE, and answered the three specific research questions that this study aimed to answer.

7.3. Research Contribution

This study used DiMaggio and Powell's (1983; 1991), and Oliver's (1991) institutional frameworks to describe the institutional forces that affect the internal audit practices. It also elaborates the concepts of institutional theory in relation to strategies and tactics chosen by the internal audit unit to respond to institutional pressures. Through an examination of strategies and tactical responses of an audit unit in relation to various institutional pressures, this study makes a contribution to the auditing literature by providing a rich description of internal audit practices of a publicly listed SOE operating in Indonesia, which has not been a subject matter of a comprehensive study previously. In this respect, this research contributes to the domain of internal

auditing and confirms the validity of the application of institutional theory as a lens to examine organisational responses toward various institutional pressures.

This study also broadened the level of examination by undertaking a two level examination as suggested by Fogarty (1996). This is in contrast to previous studies in this area (for example, Al-Twaijry *et al.*, 2003; Arena *et al*., 2006; Arena and Azzone, 2007; Mihret *et al.*, 2012) that have undertaken a single level of examination. Also, while deviating from prior studies, which have confined their analysis to examine formal coercive pressures on the internal audit practice, this study has broadened the examination by looking at both formal and informal coercive pressures which have resulted in responses affecting the internal audit practice. As a result, this study draws up a comprehensive picture of internal audit by covering broader aspects of internal auditing involving activities of all levels of auditors in the internal audit unit. This is in contrast to previous studies (for example, Al-Twaijry *et al.*, 2003; Arena *et al*., 2006; Arena and Azzone, 2007; Mihret *et al.*, 2012) which have only considered the activities of auditors at the highest level and largely ignore the input from the middle and lower level of auditors.

One of the major strengths of this study is that it has attempted to answer 'how' questions through an interpretative case study. This study also contributes to fill the gap in the literature highlighted by Humphrey (2008) who argues that there is a lack of qualitative research in examining internal audit issues. However, it must be mentioned that a few other studies which have examined internal audit practice from the institutional perspective have also gone beyond asking 'what' questions (for example, Al-Twaijry *et al.* 2003; Arena *et al*. 2006; Arena and Azzone, 2007; Elbardan *et al*. 2016 and Mihret *et al*., 2012). The fact that this study adopts a qualitative case study approach and takes into account the views of various levels of internal auditors and uses

a variety of sources for data collection provides more validity to the findings of the study.

7.4. Implications of the study

The findings from this study have potential implications for Indonesian policy makers, including professional bodies, especially in the area of internal auditing as well as the managers of SOE. The study indicated that government applied tight regulations through various government units such as Bapepam-LK/OJK, Ministry of SOEs, BPK, BPKP, and IDX to regulate the practice of internal audit in SOE in Indonesia. However, the study found the effort to monitor and evaluate the practice of internal audit of SOEs in relation to the requirement of the regulations is weak, suggesting the need for more effective actions from these organisations to improve the status quo.

Some actions need to be taken to make the internal audit function more effective. First, the government should consider making the internal audit unit report directly to the board of directors rather than to the CEO. By doing so, it can discourage interference from the top management on the internal audit practice and ensure that internal auditors perform their tasks independently. Second, the government should pay close attention to the report produced by external auditors including the assessments made by the independent assessors that refer to the quality of internal audit activities. These assessment reports can be used to identify problems and weaknesses faced by the internal audit unit and to put forward policies to address the critical issues identified. Third, the government should continuously update the recommendations published by the IIA and adopt them into the regulations to ensure the practice of internal auditing is in line with best standards. This is one of the ways to maintain and increase internal auditing effectiveness. Fourth, the government should ensure that their monitoring mechanisms are effective as this study identifies the absence of strong monitoring and

inspection mechanisms as one of the main reasons for the internal audit unit's failure to comply with government policy requirements fully.

The finding of the study indicated that the manager of the SOE needs to improve the qualifications of the auditors. This can be through formal education, professional standards and professional networks. The standards of internal auditing recommend that qualifications of internal auditors should be in line with the level of internal audit activities. As the scope of internal auditing covers control, risk management and the governance process as suggested in the standards, it is suggested that the internal auditors should have competence in those areas. The study showed that the internal audit unit attempts to follow the recommendations of the standards on internal audit activities regarding relevant competence needed by the auditors. In the case examined, the internal audit unit provides internal training, supports external training leading to the completion of professional certification and encourages employees to participate in continuous professional development programs. However, it was found that not all auditors have opportunities to attend local or international conferences and seminars. In this respect, the government should monitor and evaluate the qualifications of the auditors in SOEs regularly and take appropriate actions to encourage SOEs to educate their internal auditors when they are not doing enough to improve the qualifications of their internal auditors. At the present, there is huge vacuum in the policy setting in relation to this aspect.

In addition to the potential policy implications mentioned above, this study highlights a number of managerial implications in the following areas: the institutional environment in Indonesian public SOEs, managerial behaviour, the public perceptions of internal auditors in SOEs, and the approach of the internal audit unit to managing people. These potential managerial implications are briefly described below.

First, as suggested by Meyer and Rowan (1977), adapting to the institutional environment is important for organisations to achieve legitimacy and to be successful in the long term. The finding of this study shows that the institutional environment is not always a constraint but sometimes can be an enabling force.

Second, this study indicates that high ranking internal auditors prefer/are compelled to obey the requests of the CEOs despite the fact such actions violate the regulations and internal auditing standards. This attitude may impair the independence and objectivity of an internal auditor in conducting the internal audit activities. However, the results also indicated that the manager of the internal audit unit attempted to improve the quality of internal audit services by trying to fully adopt and implement internal auditing standards. This is a welcome development in the context of SOEs in Indonesia and is a practice recommended by IIA which is of the view that the role of the internal auditor is now being changed from watchdog to consultant. Following this action, the internal audit unit altered the audit method from a controls-based audit to a risk-based audit while making efforts to improve the proficiency of internal auditors. In terms of competencies of the internal auditors, it is evident that internal auditors recruited lacks knowledge, skill and experience in internal auditing areas. This problem occurred because most internal auditors are recruited from other business units and have no educational background in accounting and auditing. In this case, the manager has to provide internal and external training to the internal auditors and to make them engage in obtaining professional certification and participating in professional development programs. However, not all internal auditors have a similar opportunity to participate in a professional development program. Therefore, the manager needs to consider the fairness of opportunities for all internal auditors. This is important since qualified internal auditors are perceived to be auditors who are professionally qualified, have

completed a professional certificate and have experience in conducting internal audits for a reasonable period of time. Also, the manager of the internal audit unit should recruit a number of new internal auditors as the existing numbers of internal auditors are not enough to tackle all the internal audit activities.

Third, the study points out that besides acquiescence strategy and comply tactic, most of the responses of the internal audit unit towards coercive pressures are compromise strategy and pacify tactic. Because of the compromise strategy and pacify tactic, the internal audit unit has not yet been able to put all the items in the internal audit charter fully into practice. This may be due to two reasons. First, some items have been put into practice but failed to achieve the expected results. Second, the items have been put into the chapter to gain legitimacy but not are strongly supported by the auditors for implementation. Since the audit chapter functions as a mean of absorbing institutional pressures, it is incumbent upon the head of the internal audit unit to comply with the internal audit charter and make every effort to put all items in the charter into practice. The items that need particular attention are: ensuring an appropriate number of internal auditors with internal audit activities; maintaining the independence and objectivity of internal auditors; providing a fair opportunity for all auditors to participate in professional development programs; and conducting an internal quality assurance review.

Fourth, as described in chapter 5, internal auditor's roles now include the role of assurer, consultant and catalyst. The changing roles and internal auditor's engagement in much broader business functions has generated an eagerness among internal auditors to increase their professional competence. Therefore, it is essential that the manager of the internal audit unit fully understands the changing role of internal auditors and makes

an effort to provide them with opportunities to improve the competencies that are demanded by the newer roles that they are expected to perform.

Fifth, as many recruited internal auditors have different educational backgrounds and most of them have no experience in internal auditing before coming to the audit unit, the manager of the internal audit unit needs to consider the perspectives from different auditors when responding to institutional pressures.

7.5. Limitations and suggestion for further research

The findings of this study are subjected to a number of limitations. Since a single case study has been conducted to examine the internal auditing practice in a public SOE in Indonesia, the findings are subject to common criticisms of the single case study method such as concerns about methodological rigour, researcher subjectivity, and external validity. More specifically, the interpretations presented in this study are based on the findings from a specific company in a particular sector in a specific institutional environment. The institutional environment in an Indonesian public SOE context means it is uncertain the extent to which the findings of this study can be applied to other institutional contexts. Despite this weakness, single case study design is widely used in higher degree research as this limitation can be offset by other benefits that a single case study can offer in comparison to other viable methods that could have been used to examine the underline research issues. As stated by Hamel *et al.* (1993) and Yin (1994), parameter establishment and objective setting of the research are far more important in case study method than a big sample size.

Similarly, as this study investigated the practice of internal audit which took place in the context of a public SOE in Indonesia, the results of this study may not be relevant to other internal audit units that operate under different contexts and institutional environments. Yin (2014) stated that a common concern on a case study research is

inability to generalise its findings. Therefore, to increase the collection of case studies in the same area, future research should be conducted in other institutional environment contexts. By doing so, these studies can enrich the body of knowledge in the area of internal audit function practiced by different entities in different environmental settings.

The study focuses on a public SOE in Indonesia as a single case study. Future study may undertake similar research using multiple case studies either in SOEs in Indonesia or in other countries.

In summary, despite the limitations mentioned above, this study provides empirically-rich, context-specific, holistic accounts of the institutional pressures faced by an Indonesian SOE and describes how such pressures affect the internal audit practice of the Indonesian public SOE examined.

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