

**EXPLORATION OF THE
EFFECTIVENESS OF THE INTERNAL
AUDIT FUNCTION IN NEW ZEALAND**

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Executive Summary

Internal audit function (IAF) related literature is relatively scarce and IAF effectiveness is largely viewed as an under-explored “black box.” In this doctoral thesis, a mixed methods study design is adopted to provide insights on the role and effectiveness of an IAF using data from the New Zealand (NZ) setting. Motivated by agency and institutional theories, the quantitative portion of this study explores the value of IAF by examining i.) factors associated with IAF use; ii.) IAF’s influence over the quality of external financial reporting; and iii.) the impact of IAF use on external audit pricing. Using data from the NZ setting, this study extends IAF literature using firm data from a relatively smaller and less regulated economy where IAF services are voluntarily adopted. The qualitative aspect of the study relies on foundations of complex systems theory which claims that many essential questions can only be addressed by understanding the interactions and relationships of parts within a system. In performing case studies via semi-structured interviews with the chief audit executive and senior management, the objective is to share insights about the role and effectiveness of an IAF both from a demand and a supply perspective.

There is strong evidence that organisations that are larger, are publicly listed, and those that choose to use a Big Four auditor are more likely to use an in-house based IAF. I also find that firms in the financial services industry are less likely to use in-house internal audit services. From an effectiveness viewpoint, I find there is strong negative association between IAF use and external audit fees, which supports the substitution effect where better internal controls reduce external audit fees by reducing the scope of external audit work. I find no significant relationship between IAF use and earnings quality. The decoupling between IAF use and earnings quality is not entirely surprising. In the case studies, I learn that today IAF service proposition extends well beyond compliance and the traditional narrow focus on financial risk. This study supports the view that an IAF serves more than one master who often have competing expectations. There are indications of an apparent expectation gap between the role of an IAF, the expectations borne by its key stakeholders (delivery against which is a major determinant of IAF effectiveness), and performance evaluation mechanisms applied to measure IAF effectiveness.

Despite limitations of sample size, this study provides several practical and academic contributions.