

# The Role of Internal Audit in Integrated Reporting:

## A South African Case Study

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## Introduction

The International Integrated Reporting Council (IIRC) describes integrated reporting as a more holistic reporting practice that extends the traditional financial reporting focus of annual reports to a more comprehensive view that includes financial, nonfinancial, and sustainability considerations related to the business (IIRC, 2013:2-5). The move to a more holistic, complex reporting process also resulted in an increased demand for assurance with a focus on combined assurance and assurance on a greater variety of aspects, such as the nonfinancial and sustainability elements included in the new integrated reports (IIRC, 2015:13,19). As integrated reporting is a relatively new process with increased assurance demands via combined assurance, the role and impact on the various assurance providers involved in combined assurance will have to adapt and develop to stay abreast with the evolving demands of integrated reporting (IIRC, 2015:4). This case study was conducted to obtain insight into the role of the internal audit function relating to integrated reporting.

## Integrated Reporting

South Africa has a strong legacy of high-quality corporate reporting that stems from a strong technical ability to apply financial reporting and auditing standards. It is so strong that the World Economic Forum (2016:325) ranked South Africa number one in the categories of strength of auditing and reporting standards and the protection of minority shareholders' interests. In addition, South Africa was ranked third in the category of efficacy of corporate boards (World Economic Forum, 2016:325). To guide South Africa further toward improved competitiveness, the Institute of Directors in Southern Africa (IoDSA (2009:13)) recommended the use of integrated reporting in South Africa in King III. Integrated reporting means that organizations manage and report on the activities of the organization as a whole using integrated thinking, and not only report on the financial results. It was expected that using a more integrated format to report on the activities of an organization would increase the trust and confidence of the stakeholders (IoDSA, 2009:13) and help to cement a sustainable view of the process in which the capitals of an organization are used.

## Case Study

To obtain insight into the real role played by internal auditors in integrated reporting, semi-structured interviews were conducted with participants involved in the integrated reporting process within their organizations. Participants were interviewed from the internal audit function as well as the business side of the integrated reporting process. The participants from business included people involved in the first and second lines of defense. The 10 interview questions are presented in **exhibit 1**.

Exhibit 1: Interview Questions	
	Questions
1.	What is the internal audit involvement in the integrated reporting process (IIA, 2015a:32; IIRC, 2014a:29)?
2.	Who are the assurance providers involved in the assurance process of integrated reporting (IIRC, 2014a:30)?
3.	What is the scope or extent of their involvement in the integrated reporting process (IIRC, 2014a:30)?
4.	Who sets the materiality levels of integrated reporting (IIA, 2015a:32; IIRC, 2014a:34)?
5.	What skills, knowledge, competencies, and resources are required to perform an assurance and/or consulting role in the integrated reporting process (IIRC, 2015:15; Lenz & Hahn, 2015:21; Mahzan & Hassan, 2015:97)?
6.	To what extent does the compilation of integrated reporting, comprised of engineers, IT, and SHEQ <sup>1</sup> specialists, impact their role in integrated reporting (IIRC, 2015:18; Lenz & Hahn, 2015:20; Mahzan & Hassan, 2015:97)?
7.	What is internal audit's role in governance relating to integrated reporting? Are they fulfilling this role? What should they do if there is a gap (Chambers & Odar, 2015:46-47; IIA, 1999; IIA, 2015a:32; IIA, 2017c:12)?
8.	What is internal audit's role in risk management relating to integrated reporting? Are they fulfilling this role? What should they do if there is a gap (IIA, 1999; IIA, 2015a:32; IIA, 2017c:13; Radasi & Barac, 2015:97)?
9.	What is internal audit's role in creating credibility and trust of the integrated reporting process (IIRC, 2015:13)?
10.	What is your view on the independence and objectivity of internal audit relating to services focusing on the integrated reporting process (IIA, 2015a:1; IIRC, 2015:15)?

## Case Study Synthesis

The main insights from the 10 questions are:

- Participants predominantly saw the role of integrated reporting in the final or reporting stage of the integrated reporting process and not in the full process. The main objective of the internal audit assurance is to focus on the accuracy, validity, and completeness of information relating to the key performance indicators (KPIs). Due to the evolving integrated reporting process, the assurance on the process is also an evolving journey. There is, however, a need for internal auditors to continue their engagement with internal stakeholders to ensure that there is a common understanding of internal audit's role.
- Assurance providers involved in the assurance on the integrated reporting process are in line with the combined assurance framework, first line of defense, second line of defense, and third line of defense. In addition, it was also noted that board subcommittees play an oversight role.
- The compilation of the internal audit team plays a pivotal role, especially in technical processes or areas of integrated reporting, where the expertise of a technical expert is critical. Therefore, the compilation of a multiphasic internal audit function helps with their role in relation to integrated reporting. The knowledge and skills identified help the internal auditor to “move toward a consulting role to be able to see the bigger picture, connect the dots and advise—forward-looking, this is critical for value-adding.”

<sup>1</sup> Safety, Health, Environment, and Quality.

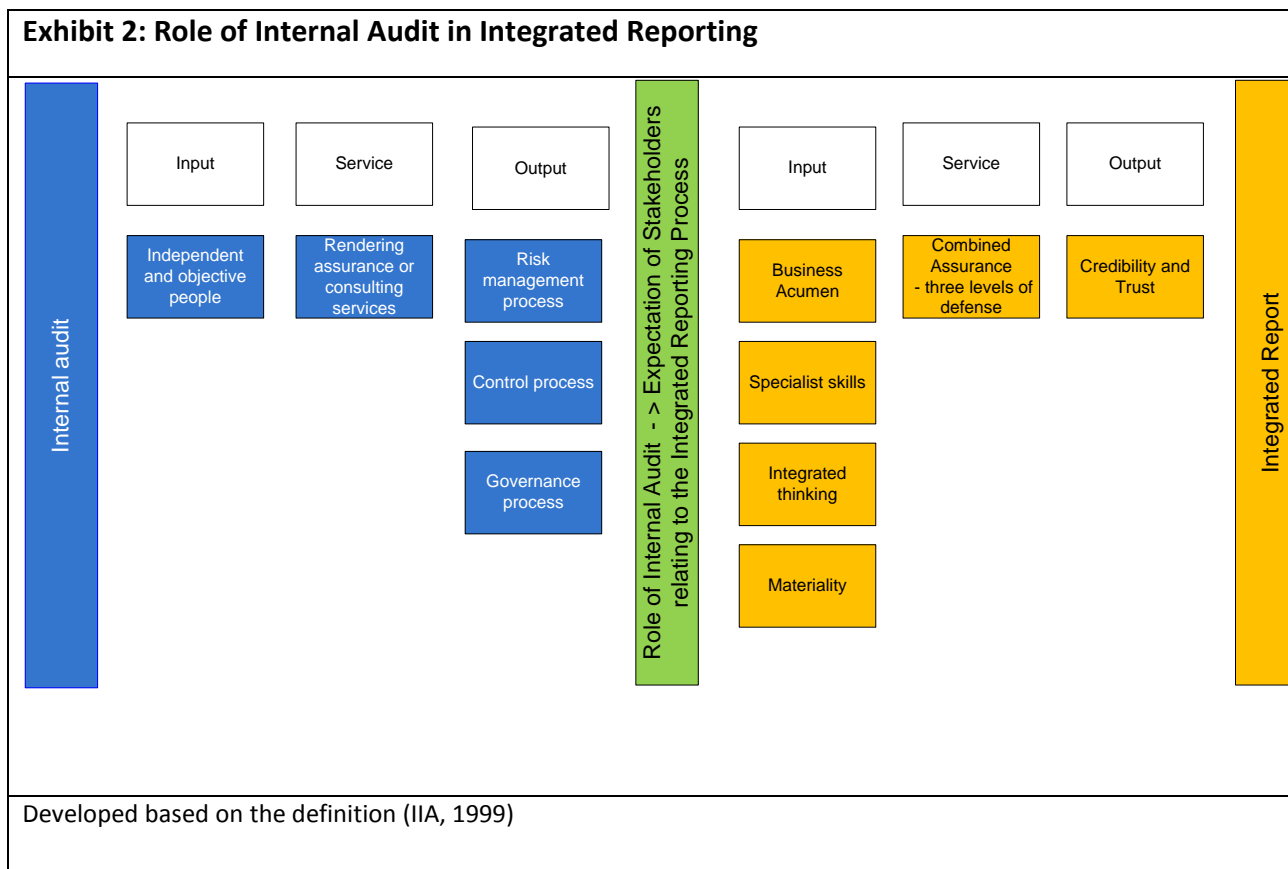
- The materiality is not set by the internal audit function, which is in line with The IIA (2015a:32), to ensure the internal audit function's independence and objectivity, as this is seen to be a management role.
- One respondent said that creating credibility and trust is the role of external audit and not internal audit. The remaining respondents stated that internal audit has an extremely important part to play in the creation of credibility and trust, thereby contradicting this view. Internal audit facilitates the organization to avoid any qualified audit reports from the external auditors, thereby enhancing the internal stakeholders' credibility and trust relating to integrated reporting. According to one respondent, "At the end of the day, this is what adds or takes away from the credibility of the integrated reporting." Senior management relies on internal audit's opinion and assessment relating to the integrated reporting process for internal assurance to stakeholders. "However, whether this is the view of the external public, this is not known." Further, the view is that internal auditors should be the champions to underpin the internal system that is fundamental to the credibility and trust of the integrated reporting process.
- All of the respondents believe that independence and objectivity of the internal audit function is critical. However, internal audit is seen as part of the organization from an external or public view. Internal audit is seen to be independent and objective internally, which is substantiated by "the recommendations relating to the findings identified by internal audit that are implemented by business."

The underpinning theme that emerged from these questions may be linked to role conflict. The following was mentioned: potential conflict may arise where internal audit does not agree with the qualitative information or text. However, internal audit provides recommendations to address identified weaknesses, and it is the prerogative of business to implement the recommendation or not. The independence and objectivity may be influenced by potential conflict, where senior management might overrule or influence the findings rating from high to medium, affecting the materiality of reporting. In addition, conflict relating to independence and objectivity may arise, where opinions may be perceived as criticizing or highlighting negligent conduct by top management. Furthermore, conflict of interest also may be a concern, where audits may impact the results of the organization's performance bonus. "You do not want to be the auditor that results in no bonus payout," as stated by one of the interviewees.

Using this insight, this study developed a model that illustrates the role of internal audit in relation to the integrated reporting processes based on the results. **Exhibit 2** illustrates the definition of internal audit, which is used as the framework for this diagram (IIA, 1999). As the internal audit definition reflects a process approach to input, service, and output, so does the integrated report.

## Model of the Role of Internal Audit Relating to Integrated Reporting

The model is illustrated in exhibit 2, followed by a discussion of each of the variables.



### Expectations

“Expectations of the stakeholders relating to the integrated reporting process” is in the center of the model. This is a key factor for internal auditors, as this is the underlying theory of the model. The internal auditors have to understand “role theory” (Ahmad & Taylor, 2009:902; Roussy, 2013:551) and need to know how it influences the expectation from the respective stakeholders (Rensburg & Botha, 2014:145). In addition, internal auditors should be aware of their own expectations relating to their role in integrated reporting (Deloitte, 2011:10; IIA, 2015a:32). A better understanding of their role will enable them to identify the requirements and goals of stakeholders to ensure that the integrated reporting and organizational goals are achieved. Internal auditors are in an ideal position to add value to the process through improved insight as they have a “seat at the table” (IIA, 2013b). Understanding stakeholders’ expectations relating to integrated reporting could be a challenge because there are different stakeholders (Rensburg & Botha, 2014:146). However, internal auditors must identify the key role of players or stakeholders and ensure that there is no unclear expectation relating to their role in the integrated reporting process.

### Input

The inputs into the internal audit definition shown in exhibit 2 are the independence and objectivity of the internal audit function (IIA, 1999). Independence and objectivity were confirmed as key inputs into the integrated reporting process relating to the role of internal audit derived from question 10. Other key inputs identified as parts of the data analysis conducted specifically focusing on the integrated reporting process were business acumen, specialist skills, integrated thinking, and materiality. Business acumen and specialist

skills are critical competencies required by the internal audit function to ensure that it fulfills its mandate and achieves the expectations from the organization's respective internal stakeholders. This is supported by Mutchler (2003:234) and The IIA's *International Standards for the Professional Practice of Internal Auditing* (IIA, 2017c:6) relating to the role of internal audit. Integrated thinking is part of the competency skillset highlighted by the interviewees (question 5) and supported by Barac et al. (2016:81). The IIA (2010:3) also emphasised that a proactive review and insight into the organization's key performance measures and strategies needed to be obtained.

The last input into the integrated reporting process was materiality. For internal audit to be independent and objective, The IIA (2015a:32) was of the opinion that the internal audit function should not set the materiality of the integrated reporting process. Based on the results of the research, the internal audit function of this organization did not set the materiality and, thereby, enhanced the view of their stakeholders of internal audit's independence and objectivity.

### **Service**

In the internal audit definition, the services provided are assurance and consulting (IIA, 1999). The services relating to the integrated reporting process are also assurance and consulting. However, the role of internal audit is dependent on the maturity of the integrated reporting process (Deloitte, 2011:10). In this case study, the focus of internal audit's role is assurance as derived from the results of questions 1 and 2 of the interviews. Key emphasis was placed on combined assurance or three levels of defense, in accordance with the results of the interviews (questions 1 to 3), to provide assurance on the integrated reporting. The first line of defense was operational or line management; the second line was seen as the oversight functions focusing on risk and compliance; and the third line was independent and objective assurance providers (IIA, 2013b:2). This was in line with the view of Ackers (2016:736) and King IV (IoDSA, 2016:31) that combined assurance should be implemented to provide assurance on integrated reporting.

### **Output**

The outputs relating to the internal audit definition are risk management, governance, and control (IIA, 1999). This is fundamental to the integrated reporting process, as the assessment of risk management, governance, and control makes the information of the integrated report credible and trustworthy.

Risk management that focuses on all aspects of the organization's performance was highlighted in this case study. This included health, safety, and environment risk management, according to Spira and Page (2003:658). The risk management and governance assurance focus in this study was mainly on the information that was reported in the integrated reporting itself. The risk management and governance of the enterprise risk management as a project needed to be assessed. However, the risk management and governance and controls were assessed by means of the annual risk-based audit plan (IIA, 2017c:4), and the internal audit function provided an annual opinion on the status of the risk management, governance, and controls of the organization in the integrated reporting. The assessment of the control environment was fundamental (COSO, 2013:32). It was also supported by Chambers and Odar (2015:46-47), who asserted that internal audit should assess the control culture, which should include the process of strategic and operational decision making.

The assessment of the key controls relating to the performance KPI resulted in credibility and trust of the information in the integrated reporting. This was in line with the overview feedback from the IIRC (IIRC, 2015:13). The key expectation of the internal stakeholders was not to have a non-qualified report relating to the assessment of performance indicators by the external auditors.

## Role Conflict

In this case study, internal audit was seen to be objective and independent, thereby enhancing the credibility and trust of the information contained in the integrated reporting. However, potential conflict of interest was raised, as the biggest concern was jeopardizing the independence and objectivity of the internal audit function. This was supported by Van Peurse (2004:379), who stated that the internal audit function might focus on the best interests of the organization and not all stakeholders.

It was found that the role of internal audit relating to integrated reporting was the same through providing services of assurance and consulting that led to an opinion on risk management, governance, and internal controls. However, the focus of internal audit relating to integrated reporting was integrated thinking, which was highlighted in question 5 of the interviews. “It is also key to the thinking of interconnectivity of information, how you are connecting the thread.”

## Conclusion

“To enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight” (IIA, 2015c).

The purpose of this case study was to use professional guidance to describe the expectation of the role of internal audit in integrated reporting and enrich that understanding through interviews—first, to understand the actual role and, second, to identify the expectations and gaps from the users’ viewpoint.

There are four critical roles for internal audit to support organizational governance relating to nonfinancial reporting (IIA, 2015b:5). Internal audit should be the catalyst for integrated thinking, provide advice on embedding and executing plans, and heighten the credibility of information through assurance and coordination with other assurance providers (IIA, 2015b:5).

Combined assurance is used in the assurance on the integrated reporting process. The aspect of the credibility of information is heightened in this case, based on the results from the interviews. Internal stakeholders need to be able to trust the information that is reflected in the integrated report. Performance KPIs are audited, which raises blind spots or areas of concern that may impact the performance of the organization, and challenges the objectivity of internal auditors. Finally, the key role of the internal audit function relating to integrated reporting is to be the catalyst for integrated thinking. This was confirmed by interviewer IA1: “It is also key to the thinking of interconnectivity of information, how you are connecting the thread...”

Integrated thinking needs to be employed by internal audit specifically when focusing on assessing the integrated reporting process and when providing assurance and/or consulting services, when assessing risk management, governance, and control relating to the integrated reporting process. It is also important to focus on the whole integrated reporting process and not just on the integrated report itself. This holistic approach fosters credibility and trust in the integrated reporting process. Internal credibility and trust lead to the non-qualification of the external auditors’ external report, which further enhances the trust of information in the integrated report. The organization also benefits from the assessment of the integrated reporting process when blind spots and emerging risks are highlighted. The non-qualified external auditors’ report and accentuation of emerging risks are the expectation of the internal customers. However, critical to the success of the assurance or consulting services is a multiskilled or multidisciplinary internal audit function. Combined assurance or the three levels of defense are the enablers of assurance on the integrated reporting process, as integrated reporting is the method of communicating the value that an organization has created through the implementation of its business model and strategic and operational decisions (Rensburg &



Botha, 2014:145). In this case study, internal audit moved from service to management to service to the organization in order to add value.

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