Exploration of a theory of internal audit: a study on the theoretical foundations of internal audit in relation to the nature and the control systems of Dutch public listed firms

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1. Introduction

1.1 Setting the scene

Recent high profile (fraud) scandals and financial crises have undermined investor confidence in the management of firms and drawn global attention to how Management Boards of public firms are in-control of their operations (Corporate Governance Committee, 2003). These scandals cleared the way for corporate governance committees in various countries to provide recommendations and define new requirements on the control systems of public firms. The background of corporate governance committees, as noted by Cadbury, seems to be a profound approach (Cadbury Committee, 1992). His committee mentions that the U.K. corporate governance code would strengthen listed companies in both their control over their businesses and their public accountability. Furthermore, companies would have the right balance between meeting the standards of corporate governance expected of them and retaining the essential spirit of enterprise.

However, the new requirements of corporate governance committees (also outside the U.K.), which were made apparent in a firm’s annual report, have not prevented new scandals. At HBOS there was “inadequate separation and balance of powers between the executive and internal and external oversight bodies, i.e. finance, risk, compliance and internal audit, non-executive Chairmen and Directors, external auditors, the FSA, shareholders and politicians” (BBCNews, 2009). In his statement on BBC News, Paul Moore said that the “real problem and cause of this crisis was that people were just too afraid to speak up and the balance and separation of powers was just far too weighted in favour of the CEO and their executive”. The new U.K. Corporate Governance code added principles with respect to Board composition to prevent groupthink; principles to promote a proper debate in the Boardroom and principles regarding the clarity of the business model and the risk tolerance as part of better risk management (FRC, 2010).

Corporate governance committees and related requirements in the U.S. did not prevent scandals at firms such as AIG and Lehman Brothers. The Committee on Oversight and Government Reform held a hearing to examine the regulatory

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1 This, for example, has led to the Sarbanes-Oxley Act in the U.S.A., which requires multinationals listed on the US stock exchange to report on the effectiveness of their internal control system.
mistakes and financial excesses that led to government bailout of AIG; through reports and Audit Committee meeting reports, they demonstrated a lack of governance and transparency at AIG, for example by excluding risk management and internal audit from some of their critical control issues (COGR, 2008). Another U.S. example is Lehman Brothers, which is the largest bankruptcy in history to date. Although management in its annual statement confirmed to comply with the Sarbanes Oxley Act, the bank could not prevent bankruptcy. One of the books on Lehman Brothers (A Colossal Failure of Common Sense) describes an arrogant, greedy and reckless Board that was not in tune with the people within the firm and not sensible about its risk behaviour (McDonald & Robinson, 2009).

Although the Netherlands already has a history of corporate governance committees and codes, Dutch society has had its fair share of governance incidents as well, such as Ahold, VNU, ABN AMRO and Van der Moolen. These firms reported that they were in-control, but from a strategic point of view these firms turned to be out-of-control (Smit, 2008; Strikwerda, 2006).

Numerous stakeholders have interests in the level of control implemented within a public firm. Key stakeholders include investors, policy makers, regulators, credit rating agencies, banks and financiers, legal, audit and consulting firms. Increased (regulatory) demands for accountability have made firms’ internal control systems part of the public policy debates on auditing and corporate governance (Maijoor, 2000). There is not one universally accepted concept regarding the control system of a firm; different concepts for internal control are assumed in various researches, depending on the academic field involved. Furthermore, control is seen from different perspectives. For example, the corporate governance codes describe control from the perspective of shareholders and stakeholder on a firm (Corporate Governance Code Monitoring Committee, 2008; FRC, 2010). COSO describes control from the perspective of management and how they can control the process in relation to operations, reporting, its assets and compliance (COSO, 1994). Others view control from a management perspective with focus on the external environment as part of the survival of the firm (Pfeffer & Salancik, 1978) or a combination of internal and external control (Fligstein, 1990).

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2 Strikwerda (2012) provides a critical view on the contributions and limits of the Dutch Corporate Governance Code to the welfare of the Dutch society.
1.2 The position and role of Internal Audit

The Dutch Corporate Governance Code (DCGC) (2008) refers to internal audit as a function for assessing the internal risk management and control systems. Furthermore, this code indicates that the work plan of internal audit, activities and results should be discussed with the external auditor and the Audit Committee.

Up to now, the internal audit profession has been involved only indirectly in the discussion on corporate governance in the Netherlands. No internal audit representative was included in the Monitoring Commission and there was no clear understanding of the role of internal audit. This understanding is growing, thanks to a more active approach and through seminars (Gras, 2006). Also, academic research should do its part in clarifying the basis of internal audit and its added value. Therefore, this study will follow the recommendation made by Rittenberg (1999) and repeated by Sarens & de Beelde (2006), that the area of internal audit is ripe for a wide variety of research and should encompass its broad nature as described in the internal audit definition of the IIA. Although Paape (2007) already noted that theoretical research on the existence of internal audit is limited, it is interesting to investigate which studies already covered the existence and scope of internal audit, and their results. In the Netherlands, there is a PhD-thesis by Paape (2007) with respect to the impact of corporate governance on the role, position and scope of services of internal audit, and a PhD-thesis from De Bruijn (2010) on the role of internal audit in relation to the laws and regulations of professional bodies. This PhD-thesis will build on those researches. The thesis of Paape (2007) in particular provides a good starting point for this thesis, due to its economic perspective. However, Paape’s thesis mainly concludes on the make-or-buy decision, seemingly neglecting a broader view on the existence of internal audit and its scope. The same applies to the thesis of De Bruijn (2010), whose area of study relates to a thorough description of the legal position of internal auditors in the Netherlands; this research could be extended by an analysis of required legislative changes from an institutional perspective and in relation to the contribution to the control system of a firm.

There are some articles, already highlighted in this introduction, that touch a relevant part of this study: Van Peursem stated that internal audit is a discipline that creates a premium on the share price, but also asked the question whether there would be more losses than benefits if there were no internal audit (van Peursem,

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3 The definition of the IIA will be discussed later in this chapter.
Handy complains about *audit mania* that leads to layers of agents checking other agents on the assumption that nobody can be trusted, and that managers and employees are selfish (Handy, 1998). Handy is afraid that this checking will lead to a self-fulfilling prophecy: that an employee’s taking responsibility is not necessary. Power (2007) is also cautious about auditing (in general) because of the fear that everything is made auditable without wondering whether there is some fit between solution and problem. Cunningham (2004: p. 7) adds to this discussion that the structure of the control-and-audit regime hides the fact that it revives an old problem of agents watching agents. That is, control seeks to govern behavior and is deemed necessary due to lack of trust. Audits of control seek to test those controls to assure behavior is being controlled. Auditors monitoring controls can only test certain kinds of controls. There is a difference between control effectiveness and control audit-ability. A corporation can have controls that are more effective but less audit-able and controls that are less effective but more audit-able. These examples make it necessary to investigate the history and origins of internal audit and its scope to analyze and understand the phenomenon internal audit.

An important step in history for the development of internal audit, as well as a large body of applied knowledge regarding internal audit can be found at the Institute of Internal Auditors (IIA). Global professionalization of internal audit began with the establishment of the Institute of Internal Auditors in the United States in 1941 (Brink, 1991; Courtemanche, 1991; Sawyer, 1996). This institute has published Standards for Professional Practice of Internal Audit, which describes the objective of internal audit. The IIA defines the field of internal audit to be:

*An independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2004).*

This most recent definition of internal audit indicates a broad role and required field of knowledge for internal audit. According to the definition stated above, internal audit should be involved at all levels of an organization. This means the internal auditor to work on control at the process level, the management level and the strategic level.
Traditionally, the internal auditor has not worked at all levels of the organization. Most authors in the field of internal audit focus on the control measures within operational and financial processes (Sawyer, 1996; Spira & Page, 2002). This focus is largely determined by their audit approach. Internal auditors traditionally use the cycle approach to evaluate control procedures and techniques. This approach gives consideration to objectives (such as authorization, compliance, accounting and safeguarding assets) and is linked to the cycles of business transactions, following transactions throughout the firms’ systems of control. Some authors recommend to keep focus and maintain the expertise in traditional accounting type of control and not turn internal audit into a *jack of all trades – master of none trap* (Burns, Greenspan, & Hartwell, 1994).

The latter approach seems to miss out critical elements with respect to the context of internal audit, the firm (business) and the institutional environment. Business complexity and a changing environment lead to a need for innovation, growth and adaptation of firm’s organizational structures and processes (de Geus, 1997; Prahalad & Bettis, 1986; Simons, 1995). Corporate management’s primary role relates to the coordination and realization of changes in strategy, structure and the (re-)allocation of resources. The tasks and changes at the corporate level affect the design of the control system of the firm. These developments in control could be viewed to be part of internal audit’s domain. The question to be asked and answered is whether internal audit is part of the control system or whether the control system is an audit object of internal audit. Some authors state that internal audit should take the control system as a whole as its scope (Geeve & Molenkamp, 1998; Paape & Korte, 2000). These authors seem to define management control, besides process control, as the complete scope of a control system. However, this is incorrect, as it should also include strategic control. This is acknowledged implicitly by the original author with respect to management control – Robert Anthony. Anthony (1995) describes strategic control as the process of deciding on the goals of the organization and the strategies for attaining these goals versus the management control process of deciding how to implement strategies.

One possible issue for internal auditors is that there may be a gap between the IIA’s vision, its practical application, and management and external stakeholder needs (Spira et al., 2002). Profound academic research of the function of internal audit within the context of the governance and management of a firm and its institutional environment is needed. It is, therefore, relevant to conduct research on the reason of existence of internal audit, its scope and the subject of the audits themselves. From an academic perspective, it is interesting to sort out the
background and theories surrounding internal audit functions. Paape et al (Paape, 2007; Paape, Commandeur, & van der Pijl, 2005) indicated that there are no major established theories regarding internal audit, which raises a question regarding the status and fundamentals of statements and judgments made by internal auditors.

1.3 A Framework for control

The COSO\(^4\) framework has become the most quoted framework in discussions on control systems within corporate governance committees (Corporate Governance Committee, 2008) and by regulators (PCAOB, 2004). The COSO control framework appears to be an institutional rule and seems to function as a myth, which is embraced and legitimized by auditors, firms, regulators, and others, but does not enhance survival prospects of the firm (Meyer, 1977). The concept of control implied by the COSO-framework can even decrease the real control (system) of a firm, focusing attention on a narrow definition of control restricted to maintain legitimacy in a regulatory environment instead of survival. Recent problems with a number of firms, some of which published an in-control statement based on the COSO framework, raise questions with respect to the effectiveness of the control system of these firms. Furthermore, it raises questions regarding whether the COSO framework is a complete framework to achieve a sufficient system of control, or that quintessential elements or aspects might be missing? Below, the COSO framework itself will be scrutinized for theoretical groundedness.

The COSO framework was developed in the 1990’s by the Committee of Sponsoring Organizations of the Treadway Commission, in response to discussions about an integral internal control framework (COSO, 1992). The purpose of the Committee was to formulate an unequivocal definition of internal control, because at the time, internal control meant different things to different people. The Treadway Commission wanted to create one common definition so that managers, legislators, auditors and others could understand one another. In the COSO report (1992, 1994: p. 13) internal control is defined as:

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\(^4\) The COSO committee has submitted a public exposure draft of the updated internal control – integrated framework in December 2011. The final version will be published in 2013.
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 COSO definition seems to combine internal control and management control (Vaassen, 2003), thereby enlarging the scope of internal control to encompass different levels of an organization. While internal control’s unit of analysis was traditionally on transactions and the reliability of management accounting information, its point of view has now been extended to include the managerial focus on operational efficiency (which includes also effectiveness).

Furthermore, the COSO definition of internal control of 1992 is less technocratic (i.e. procedure-minded) than previous definitions. Its description includes more attention to people. Control is viewed as a process that requires actions from people within the organization and also pays attention to items such as integrity, management style, information sharing and communication (COSO, 1992).

A further discussion on the combination of internal and management control is included below in the comparison of the COSO definition with the management control definition of Anthony. Anthony describes management control as the process by which managers influence other members of the organization to implement the organization’s strategies (Anthony, 1995; p. 8). There is consistency between the definition of Anthony and COSO with respect to the element process, e.g. control is not a static element but a process which requires attention from various people within the firm. A difference between the definition of Anthony and COSO relates to its end result; COSO aims at the achievement of objectives, while Anthony aims for the implementation of strategy. These elements are related, but different. Furthermore, both definitions lack a description of what control actually is.

A more comprehensive definition of management control is provided by Merchant & Van der Stede: Management control includes all the devices or systems managers use to ensure that the behaviors and decisions of their employees are consistent with the organization's objectives and strategies (Merchant & Van der Stede, 2003: p. 5). This definition is more clear with respect to how control should
be achieved (devices or systems), its aim (both objectives and strategies) and its theoretical background, by linking it to the cybernetic and systems approach as a theoretical basis.

A missing element in both the COSO definition and the management control definitions is a focus on the external environment of a firm. Control is also needed because firms are part of a competitive environment in which there is an imperfect market with unexpected changes, there are competitors influencing each other and there is a need for access to the resources as necessary for its continuity in the long term (Fligstein, 1990; Pfeffer et al., 1978). Control on strategic level is not included in the scope neither in the management control theory nor in COSO. Especially COSO limits the scope of control on financial reporting and audit. This is particularly apparent in the attention given to audit terms such as ‘reliability of the financial reporting’ and ‘compliance with applicable laws and regulation’. This focus relates to the background of many COSO member organizations that have a strong audit or compliance objective, such as the American Institute of Certified Public Accountants (AICPA) and the Institute of Internal Auditor (IIA).

Furthermore, the motivation for the COSO framework originates in the incidences of financial reporting fraud in the US. Therefore, it is not surprising that the framework reflects a strong tendency towards audit and compliance and is regarded as the standard of control by auditors (Renes, 2002). COSO seems to have a broader definition of control, but has not yet managed to implement this definition in all its breadth within its own framework.

In 2004, the Treadway Commission’s Committee of Sponsoring Organizations (COSO) published a new framework, Enterprise Risk Management - Integrated Framework and Related Application Techniques (COSO, 2004). This framework is not intended to replace the internal control framework from 1992; rather, it incorporates the internal control framework. It is expanded to include attention to a firm’s strategic level, risk appetite and risk management.

Both COSO frameworks claim to have included principles or criteria which can lead to a statement regarding operational effectiveness and efficiency.

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5 Which is curious because chartered auditors are not trained in management control, but only in the control of systems and procedures with respect to management accounting information as needed for the Annual Report. In the Netherlands, a separate academic study and a degree exists for this discipline (Executive Master of Finance and Control). Those with this degree can register as chartered controller.
Nevertheless, the question remains whether COSO and its criteria are specific and complete enough. First of all, insufficient theoretical basis has been provided for the COSO framework to offer an appropriate answer to the previous question. Secondly, in reviewing older literature on audit, it is peculiar that the specification of the COSO framework focuses primarily on internal accounting control and the organization’s accounting discipline. Around 1961, Mautz and Sharaf (1961/1985) already identified that audit is an applied discipline, which means that it takes its principles and theories from other fields. They noted that the academic fields that influence audit include accounting, law, ethics, management, communications and others (Mautz & Winjum, 1981).

Another question is whether COSO is being used properly, because there is a difference between emphases on form and stress on content. Focus on form rather than content can explain why many control systems, such as COSO, do not provide real control but only pseudo control (Hofstede, 1978b). Hofstede describes pseudo control as the state of affairs in which a system is under control on paper, but not in reality. This is made apparent by all the new control requirements as part of corporate governance committees and national laws, which were made apparent in a firm’s annual report, but which have not prevented new scandals.

In addition, the use of language with respect to control is hazy, as there are different interpretations. As a consequence, people do not understand each other’s vocabularies and follow-up action. COSO aimed to formulate an unequivocal definition of internal control as it was aware of the different meanings of internal control to different people, however, it has not succeeded as yet. This, too, will be discussed in the next chapters of this study.

1.4 Object of research

The purpose of this research is to explore the academic and professional literature and current practice to develop clarity regarding the theoretical and practical contributions to and limits of the existence and the scope of work of internal audit in relation to the control system of the firm. To date, debate on the reason d’être of internal audit, its theoretical background and its contributions to and limits for the control system of the firm is continuing still. No adequate theory exists regarding the role and contribution of internal audit to control and its operationalization in a

6 There has been discussion about what constitutes an adequate theory. This will be discussed in 1.6 Research Setting.
control system of the firm, which hampers adequate development of this profession in relation to developments in the economy, in particular developments in the micro-economics of the firm.

In addition, COSO’s approach is too limited and does not cover all dimensions of a control system in terms of scope and mechanisms. Contemporary language and meanings do not seem to be congruent with actual (management) practice and the scope used in COSO is not in line with the broad meaning of control. Cases of collapsing firms still arise despite the fact that several institutional measures have been taken to prevent this. This research presents a more multidisciplinary angle to strengthen the awareness and clarity of the relevant variables regarding the control system of a firm. According to Drucker (1980), the greatest danger in times of turbulence is to act with yesterday’s logic and without a clear theoretical framework. We need to search for a profound theory to enlighten the role of internal audit in relation to the control system of a firm. This theory is to be found in the theory of the firm and the economic organization theory respectively, including its institutional context and the theory of control.

1.5 Research questions and aim
The central research question relates to the following:

*What are internal audit’s reason of existence and scope of work in the control system of the firm?*

This central research question will be explored further by the following sub-questions:

1. *What are the origins, purpose and scope of internal audit?*
From an academic perspective, it is interesting to sort out the background and theories surrounding internal audit functions. Paape et al (2005) indicated that there are no major established theories regarding internal audit. This raises the question regarding the origins, purpose and scope of internal audit. This research complements previous research on the role of internal audit in the control system of the firm.

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7 The set-up of this central research is in analogy with the key attention areas of a theory of the firm: (a) why does a firm exist (its purpose), and (b) what determines its scale and scope (see also Connor, 1991: p 123).
It also describes how the role of internal audit has evolved over time and illustrates how certain external, institutional developments have influenced their role within firms. This will also show the impact of globalization, enforcement of corporate governance and efforts of the Institute of Internal Auditors.

2. **How do internal audit and the control system of the firm fit into a wider theory of the firm?**

The exploration of a theoretical foundation is performed first of all by looking at the theory of the firm as a meta-theory for analyzing the assumptions underlying a control system of a firm from an economic point of view. Internal audit, both as a function in the internal governance of the firm and as a profession is expected to be based on assumptions regarding the nature of the firm, or a theory of the firm. In addition, the fit of internal audit and the theory of the firm will be discussed. The theory of the firm in its present state of development is far from homogenous and involves different views. However, these different views (agency, transaction costs, and resource-based view) provide different dimensions/issues that can be complementary to each other and to internal audit in analyzing control issues within a firm.

3. **How does the control system of the firm fit into the theory of control and what are the critical elements of the control system?**

Various views on control will be investigated to explore broader theories and criteria in relation to the assumptions and scope of control. The formal study of control is cybernetics. On the whole, biological cybernetics and information theories are useful in investigating the control system of a firm. Control is the acquisition and processing of (external) information in order to steer flows of energy and matter in such a way, that the living system remains viable in a changing environment (Beniger, 1986). This is in line with firms who are information-driven constructions, compete with their rivals and align with their environment to adapt and remain alive. In addition, an integrative view will be summarized, which includes relevant elements of control.

4. **What explains at an institutional level the existence and deployment of internal audit in the Netherlands?**

This research will include empirical investigations by analyzing the existence of internal audit functions within listed firms in the Netherlands. This analysis will aim at the AEX, AMX and AScX firms at the NYSE Euronext in Amsterdam. Together, these firms represent all industries of the Dutch economy. The analysis of criteria can provide more insight into the fundamental premises of internal audit. Furthermore, the non-existence of internal audit functions at some listed firms in
the Netherlands could provide new perspectives and arguments why internal audit is not relevant for them to remain viable firms.

5. How does the actual scope of work of internal audit functions of AEX listed firms in the Netherlands match with a broader, multidisciplinary view on the control system of a firm?

Another part of the empirical investigations will analyze the actual practice of internal audit functions of AEX listed firms in the Netherlands. The aim of this empirical research is to explore the match with the theoretical explorations and actual practice.

6. What explains possible differences between the internal audit functions’ scope of work and the theoretical model for control and what are or should be the consequences of these differences?

An essential element of the empirical research is to discuss possible differences between theoretical explorations of internal audit as set out in this thesis and the control system of the firm. The empirical explorations and discussions of Dutch AEX listed firms should lead to more clarity on the contributions to and limits of internal audit with respect to the control system of the firm.

1.6 Research setting

The setting of this research is exploratory. As mentioned above, there are no major established theories regarding internal audit and only developing comprehensive theories relating to the control system of the firm. The aim of this research is to structure existing theories and relations in such a way, that it generates insight into and meaning regarding the phenomena internal audit and a control system of the firm. This is in line with Stebbins (2001: p. 3) who describes exploratory research in social sciences as the broad-ranging, purposive, systematic, prearranged undertaking designed to maximize the discovery of generalizations leading to description and understanding of an area of social or psychological life.

Explorative research is mostly seen as a first step in developing a theory\(^8\). The question is: What is a theory? In general, it is defined as a statement of relations among concepts within a set of boundary assumptions and constraints (Bacharach, Böhme distinguish three phases in the development of theory: exploratory or pre-paradigm phase, paradigm phase and post-paradigm phase which is called the Finalisierung of science (Boehme, G., van den Daele, W., & Krohn, W. 1979. *Die gesellschaftliche Orientierung des wissenschaftlichen Fortschritts*. Frankfurt: Suhrkamp.).
1989: p. 496). However, there is also much discussion on what a good theory is. Some are of the opinion that a good theory is a limited and a fairly precise picture, not covering everything as it will not meet the parsimony criterion (Poole & Van de Ven, 1989). Others claim that the use of the word theory is not always clear because its references are diverse and the word often obscures rather than creates understanding (Sutton & Staw, 1995).

This research does not start from scratch, because large volumes of theories and research already exist. One way to demonstrate value, is to highlight relations and how additions significantly alter the understanding of phenomena which are researched (Whetten, 1989). In addition, Whetten (1989: p. 493) mentions that science is facts, just as houses are made of stone. But a pole of stones is not a house, and a collection of facts is not necessarily science. Therefore, in line with the elements of Whetten (1989), this research will contribute to the theory of internal audit and the control system of the firm by explaining what these phenomena are and how they relate to each other and the underlying assumptions (why). In addition, they will be set in the current context and be related to Dutch listed firms.

1.7 Research method

The methodological approach of this research covers multiple data sources, multiple theories and multiple methods, which is also called triangulation (Patton, 2002). The purpose of triangulation is to gain an overall picture from different perspectives which should also lead to a consistent view and answer to the specific research questions.

An important method for this exploratory research concerns analysis of academic journals and papers concerning the phenomena internal audit and control systems of the firm. The purpose of this analysis is to identify and understand the content of available research with respect to the phenomena of my research. Articles and papers were searched for and collected via university databases Academic and Business Source Premier and journal collections from JSTOR, Sage, Science Direct, SpringerLink and google scholar. Articles and papers were searched on the terms internal audit, internal control and internal control system of the firm, theory of control, control. Also references in collected articles linked to other related articles were taken into account.

Complementary to existing IIA research, which is based primarily upon quantitative data (Sarens et al., 2006), more qualitative data for research has been
collected by using semi-structured interviews with representatives of the internal audit function of Dutch AEX firms. This qualitative data should lead to more in-depth insights into the scope of work of internal audit within the Netherlands and possible reasons why their scope deviates from the theoretical insights. The understanding of the interview data will be supported by content analysis on relevant documents, such as the internal audit charter, internal audit plan and other reports.