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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2. Origins of and developments in internal audit

2.1 Introduction

To understand the existence and the scope of the internal audit function we need to understand its origins, the influence and contexts under which it developed, especially in the Netherlands.

Internal audit has been a *rising star* in the world of controlling a firm’s business, reaching its peak around 2004, when the chief financial officer for Pitney Bowes Inc., told CFO Magazine that internal auditors were like rock stars (Leibs, 2004). He was referring to the post-Enron reforms when internal audit was given greater responsibilities and power.

Around the same time, some voices were suggesting that 21st century internal auditors must be prepared to *audit* virtually everything — operations (including control systems), performance, information and information systems, legal compliance, financial statements, fraud, environmental reporting and performance, and quality (Ratliff & Reding, 2002: p xi). The question is which assumptions and paradigms might qualify internal audit to *audit* everything. What are the postulates of the existence and scope of internal audit?

A few years later, discussions started about whether internal audit had become irrelevant, as internal auditors had not been mentioned and/or blamed for any aspect of the financial crisis — nobody asked the question: *where were the internal auditors?* (Marks, 2010; Molenkamp, 2009; Paape, 2009). This is indeed noteworthy, as the financial crisis of 2007-2010 was also about risk management and effective control. Either internal audit did a proper job, which then raises the question of relevance, or internal audit is part of the problem. Obviously, the control problem of the firm, as the events of the financial crisis suggest, reside at a higher level beyond the level of accounting information systems.

At the same time, the Institute of Internal Auditors (IIA) made positive observations about the role of internal audit. A recent study by the IIA on the characteristics of internal audit suggested unprecedented growth opportunities due to advances in technology, the expansion of communication capabilities and the increasing complexity and sophistication of global business operations (Alkafaji, Hussain, Khallaf, & Majdalawieh, 2010). Again, the question arises what the
postulates of the existence and scope of internal audit are. It seems as if different people or groups have different interpretations or views.

To date, there is little theoretical basis with respect to the question of why internal audit exists as a separate function within a public firm. Some events in recent history (such as the establishment of the IIA, accounting scandals, regulations, etc) have changed the role, position and perception of internal audit functions profoundly. This role has also been influenced by external changes: Spraakman performed an historical analysis and indicated in 2001 that internal audit, as a profession, was being forced to find a new mandate because its root activity (support management to ensure the completeness of financial (accounting) information) was taken over by low cost and company-wide (IT) systems. (Spraakman, 2001). However, the old mandate returned due to the post-Enron reforms as a result of which the reliability of financial statements became emphasized, which appeared not to be integrated in those systems. The need for a new mandate exists, however the post-Enron reforms made the regulatory environment regress to the old mandate.

The historical development of internal audit is the focus of this chapter. Yet, in light of the lack of clarity with respect to different points of view on academics, practitioners and institutes (such as the IIA) it is considered relevant to assess the existing literature from different angles, in order to identify a common view and to prevent mixing up the theory in use and the espoused theory by practitioners (Argyris, 1999).

Therefore, this chapter will clarify the existence of internal audit and its scope of work based on the following four elements:

Firstly, history clarifies its origin, going back to 3500 B.C. This review on literature on the history of internal audit should clarify some main reasons and assumptions, not just in the Netherlands, but also on a global scale. The history of internal audit in the Netherlands is rooted in the beginning of the 19th Century. Large Dutch firms, such as Philips and Dutch Railways, had already established internal audit functions in the late 1930s.

Secondly, there exists a global Institute of Internal Auditors (IIA) that performed groundbreaking work for the professionalization of internal audit since its establishment in the United States in 1941. The IIA developed a definition of internal audit that is used and recognized by internal audit functions and regulators
the world over. Furthermore, its research can provide insight into assumptions and developments.

Thirdly, from a regulation point of view, insight can be provided into the reason of existence of internal audit. More specifically, the existence of internal audit is related to the developments in corporate governance. Some initiatives are the corporate governance codes and the internal audit requirements under the New York Stock Exchange corporate governance standards.

Fourthly, this chapter complements previous literature reviews covering this area. Paape performed research on publications between January 1994 and April 2005, revealing that academic literature on internal audit is limited (Paape, 2007). This chapter will build on Paape’s prior study to the present (see appendix I).

2.2 Historical roots of Internal Audit (until 1930’s)

Audit dates back to the Mesopotamian civilization around 4000-3500 B.C. (Ramamoorti, 2003; Sawyer, 1996). Formal record-keeping systems were introduced by organized businesses and governments, to allay their concerns about incorrect accounting of receipts and disbursements and collecting taxes (Ramamoorti, 2003). The need for and indications of audits can be traced back to, among others, public finance systems in Babylonia, Greece, the Roman Empire and the City States of Italy, all of which developed a detailed system of checks and counterchecks to prevent bookkeeping errors and inaccuracies, as well as fraud and corruption (Ramamoorti, 2003).

In Europe the first indications of an audit practice are found in ancient Rome. Through hearings, verifications were made of record keepers and their financial accounts, designed to prevent fraudulent acts (Sawyer, 1996). The task of hearing the accounts gave rise to the term audit, originating from the Latin auditus or audire, which means a hearing or to hear/listen. These hearings played an important role at that time, since not many people could read and write. The auditors were selected by the community and were expected to be competent and professional in recognizing fraud and errors (Dittenhofer, 1984).

At the beginning of the 13th Century, the first two official state auditors were appointed in the city of Pisa: an internal and an external auditor (Filios, 1984). This led to the practice of keeping two parallel sets of books for audit purposes.

Towards 1900, the audit profession developed a more systematic approach and became more extensive. The association of professional auditors was established in
the 16\textsuperscript{th} century in Venice, Bologna and Milan. Prior to this, internal auditors were mostly state auditors who acted on behalf of the king and/or state. During the 16\textsuperscript{th} to 18\textsuperscript{th} centuries, the work area of audit expanded to include the transactions of a business-oriented society. The focus remained on fraud detection and prevention by verifying each transaction with the supporting source documentation (Gupta & Ray, 1992).

The origins of the more recent internal audit functions can be traced to the 19\textsuperscript{th} century U.S. and U.K. railways (Sprakman, 2001) and the related development of accounting systems (Johnson & Kaplan, 1987). To oversee these diverse and dispersed operations, new procedures were invented, accompanied by effective management accountancy systems to coordinate the logistic, conversion and distribution activities (Johnson et al., 1987). When in the 1840s the railway firms began to conduct large-scale financial transactions at widely dispersed geographical locations, they appointed internal auditors to monitor the processing of financial transactions (e.g. payment vouchers, cash balances, station revenues). The focus of internal audit was on the financial processes and was very similar to what now is called financial audit. In addition, internal auditors also investigated non-financial data such as quantities of parts in short supply, adherence to schedules, and the quality of products (Ramamoorti, 2003).

From the 1930s onwards, the Securities and Exchange Commission (SEC) required firms to provide audited financial statements if they wanted to be registered at the Stock Exchange (Gupta and Ray, 1992: 3). This increased the work for external audit firms and had consequences for their approach of work. Increasingly, the external firms worked with sample sizes and limited their detailed verification work to transactions. This change of approach by the external auditor strengthened the establishment of internal audit functions within firms, in order to complete the detailed verification activities of transactions, which were previously performed by the external audit firm. In that sense, the internal audit function could be seen as an extension to the work of the external auditor.

As firms became larger and more complicated, and, therefore, management’s ability to monitor its operations became more limited, the role of internal audit functions increased (Sawyer, 1996). In most cases, the internal audit function was a sub function of the accounting function and performed accounting related audits (Brink, 1991). The internal auditor usually had some kind of quality control function, e.g. to verify that the accounting operations of the organization were performed correctly to instructions and standards (Courtemanche, 1991). The
external auditors continued to have a strong influence on the work and the approach of internal audit, from the perspective of the task of the external auditors, being the assurance of a reliable financial statement.

2.3 Roots and Developments of Internal Audit in the Netherlands

The history of internal audit in the Netherlands dates back to 1477, when the Dukes of Burgundy installed a General Audit Office (Algemene Rekenkamer) in the Netherlands to verify transactions related to the expenditures and receivables of their widely dispersed properties (NRC, 1999). In 1814, the General Audit Office of the Netherlands was set up in its present form, to audit the reliability of the financial statement, but also to audit the effectiveness of government laws and policies.

Internal audit within Dutch public firms emerged during the late 1930s, e.g. at Philips’ Gloeilampenfabrieken N.V. (now Royal Dutch Philips Electronics) and the Dutch Railways (Nederlandse Spoorwegen), as a result of internationalization and decentralization (Smith Committee, 2003). The primary task of the Dutch internal audit function was to audit and certify financial statements (Goudeket, 1956). Internal and external auditors were seen as servants of the same purpose (a reliable financial statement) and differed in position only; internal audit was accountable to management, while the external auditor had a public role and was accountable to the shareholders (Breedveld-Krans, 1991; Goudeket, 1956). Furthermore, in the Netherlands the internal and external auditors received the same (technical and skills) education and training (Hope & Fraser, 2003).

The Royal Dutch Institute of Chartered Accountants (NIVRA) pursued to give the internal attestation function a legal basis, but this never became part of Dutch law (Hope et al., 2003). Nevertheless, management of Dutch firms judged that having its own internal audit function was important, to acquire internal knowledge on audit, experience within the firm, and to save on the costs of an external auditor (Breedveld-Krans, 1991). In addition, due to the growth and internationalization of Dutch firms, internal audit was able to support management in monitoring the existence and operating effectiveness of control and securing its (financial) control in foreign countries (Hope et al., 2003).

From the 1980s and 1990s onwards, the awareness of management on a broader role of internal audit increased. Wildschut started the discussion about the internal audit's supporting role to management in relation to the effectiveness of processes
(Wildschut, 1976). After the 1980s, the operational scope of many internal audit functions evolved from financial audit only to include operational audit as well (Breedveld-Krans, 1991; Den Butter & Verkaik, 1993).

Due to economic circumstances across the globe, firms were restructuring, including the position of internal audit (McNamee & Selim, 1998). The management of some firms considered that from a cost-benefit perspective, the financial audit work could be completely outsourced to the external auditor. Other firms kept the internal audit function and made the change towards a mix of financial and operational audit (Breedveld-Krans, 1991).

In addition, discussions started about more distinct audits, such as ISO (International Organization for Standardization), TQM (Total Quality Management), legal, environmental and health and safety audits besides financial and operational audits (Paape, 1995). Discussions also showed a further shift from financial audit and auditing the reliability of historical information towards the examination and evaluation of the quality of a control system designed to assure the accomplishment of a firm’s goals and objectives (Paape, 1995). This change in scope was not supported by all audit directors; some audit directors took the position that financial audit was the basis and the main focus of the audit function (Ekelschot, 1993).

The professionalization of the internal audit practice grew in the 1990’s with the development of an internal / operational audit education at the University in Rotterdam (in 1993) and later also in Amsterdam. This education was specifically oriented on internal auditors, not the external auditors. In addition, the Dutch Association of Internal Auditors (VRO) was initiated to promote operational audit in the Netherlands in 1994 and, consequently, the interests of its members registered as operational auditor. These initiatives separated the internal audit practice from the dominance by the Royal Dutch Institute of Chartered Accountants (NIVRA), which is the professional body for the external auditors, but also the chartered accountants (RA’s) who were acting as internal auditor.

In 1997, the Dutch chapter of the Institute of Internal Auditors (IIA) was established as promoter of the interests of all internal auditors in the Netherlands (Smith Committee, 2003). The Dutch institute contributed to the

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9 The first professional body for internal auditors originates in the mid-1980s, when the Internal Accountants’ chapter (INTAC) was established as part of the Royal Dutch Institute of Chartered
professionalization of its field, among others by some publications relevant to this study. Especially the empirical, current state reports, such as *The Role of the Internal Auditor regarding Internal Control and Accountability* (IIA, 1999a), the three reports on the Competency Framework for Internal Auditing in the Netherlands (van Kuijck & van Zandvoort, 2002; van Kuijck & Vincenten, 2003; Vlak, 2001), the two *Position Papers* on the role of internal audit in the Netherlands (IIA, 2008; IIA & Intac, 2005), Alliés in Governance concerning the relationship with the Audit Committee (IIA, 2008), the *Relationship of the Internal and External Auditor* (IIA & Nivra, 2009), the *Role of Internal Audit as Spider in the Governance, Risk and Compliance (GRC) Web* (IIA & Nivra, 2010) and Study report: Common Body of Knowledge (CBOK) (IIA, 2010b). Overall, the publications provide insight into the current state of affairs. However, these reports should not be seen as mandatory guidance documents, to be used as professional standards by Dutch internal audit functions. Furthermore, the principles of the reports generally are linked to standards set by the global IIA. However, there are no publications with respect to required professional standards covering future outlooks\(^\text{10}\) or research from an institutional perspective; on the contrary, they are descriptions of internal audit functions’ going concern and described from a closed system environment setting.

To clarify the development in the scope of internal audit, the relevant elements from the reports will be described below.

### 2.3.1 Role of internal audit

The first report of the Dutch IIA concerned the role of internal audit in relation to control and accountability (IIA, 1999a). The report acknowledges the shift from financial and compliance audit to operational audit, but also notes the *hype* surrounding the word operational audit. Various internal auditors each have a different explanation of the term, varying from *accounting control* to *overall

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 Accountants (NIVRA). This body promoted the interest of the *accountants* who were working as internal auditor. By the end of 1997 there were three different organizations for Internal Auditors – INTAC, VRO and IIA-NL, as well as an organization for EDP auditors (NOREA) to promote the interest of the Electronic Data Processing (EDP) auditors. The various organizations are linked to each other to coordinate activities. As of 2006 the VRO and IIA Netherlands integrated both organizations.

\(^\text{10}\) Except for the U.S. based study on the Common Body of Knowledge. The data from this report are based on 2006-figures, which makes looking towards the future in 2010 more difficult.
quality of a company's internal control\textsuperscript{11}. A logical interpretation of the scope of operational audit would be ‘operational activities’ or ‘the operations’. This is different from an audit on the controls for financial reporting, although there can be some overlap. In general, the members of the IIA concluded that internal audit should have a wider scope than just reliability of financial reporting information\textsuperscript{12}. Efficiency of the primary process should also be in the scope. As a consequence, a more multidisciplinary audit function was suggested to manage this broader scope with sufficient quality.

The 1999 IIA report acknowledged that internal audit should take a more proactive role, for example help management proactively in projects, instead of only being a reactive reporter. It is interesting to note that the report considers specific types of audit, such as health and safety, environmental, legal and ISO, as something outside the internal audit function. In 1999, no need was expressed to link these types of audit to internal audit, or to integrate them within the internal audit function. This point of view changed in the years that followed.

A last point to note is the position of internal audit in relation to the Management Board and the Audit Committee. In approximately 50\% of the firms in the scope of

\textsuperscript{11} Different descriptions continue to be published. For example: in the IIA/NIVRA publication on the relationship between the internal and external audit of 2009, operational audit is described as \textit{investigations into the quality of information, such as in control statements, risk management, integrity, compliance with laws and regulations, operational process control, project and program management and sustainability}. This description assumes the old dichotomy of financial versus operational audit, while the current practice assumes the existence of more kinds of audit than only these two.

\textsuperscript{12} As the report does not cover any definitions of financial, compliance and operational audit, Paape's definition will be used. Paape (2007) is the first academic who wrote a dissertation on the role of internal audit. He provides clear definitions of the different kinds of audit:

- **Financial audit**: an audit of financial statements enables the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.
- **Compliance audit**: an audit to assess whether the organization adheres to certain specific requirements of policy, procedures, standards, laws and governmental regulations.
- **Operational audit**: an audit of (parts of) a firm's management control (or internal control) system to provide additional assurance that this system will enable the firm to reach its objectives and, if needed, provide advice for improvement. A comment on the latter definition is that it seems like a management audit, while operational audit is more expected to be focused on operational activities as opposed to management activities.
the report\textsuperscript{13}, an Audit Committee was established. In those firms with an Audit Committee, the internal audit function discussed the audit planning and reports in the Audit Committee. The report notes that the primary focus of the Audit Committee was on the reliability of the financial statement, and that the attention for a broader system of control was considered only limited.

\textbf{2.3.2 Professional Practices and Competency Framework}

Between 2001 and 2003, the Dutch IIA published three reports on the Professional Practices and Competency Framework of internal audit in the Netherlands. These studies were a result of the global IIA Competency Framework report. The Dutch IIA wanted to investigate the way the global IIA Competency Framework could be applied in the Dutch environment.

The \textit{first} report describes the summary of the global IIA research reports regarding the Competency Framework (Vlak, 2001). This report first focuses on risk and change — internal audit should be seen as a change agent — and then on who should cover all significant risk areas. Therefore, the scope here is much broader than the scope of financial audit. Implicitly, a limit is set to that scope, as the audit areas relate to operational, financial, compliance and IT audits. There is no specific reference to, for example, management or strategic audit, governance or risk management. Another issue relates to independence of the internal audit function, which is thought to be less relevant and more a state of mind and appearance\textsuperscript{14}.

The \textit{second} report describes the growing importance of IT in relation to the control system of a firm (van Kuijck et al., 2002). This is also visible in the priority rating given to internal audit tasks: (1) reliability of information; (2) reliability of automated systems; (3) efficiency of business processes; (4) compliance; and (5) control of business risks. As also to be noted from the report, elements such as business risks and the quality of processes are not among the top-three focus areas. Risk and quality of processes are thought to be covered by other \textit{assurance}-related

\textsuperscript{13} The report covered 30 firms varying from public, private and not-for-profit sector firms.

\textsuperscript{14} \textit{De Accountant} of February 2005 discusses the combination of the role of internal auditing and control within the Dutch firm Hagemeyer. The discussion concerned perceived independence issues of checking one’s own work. Hagemeyer argued that the group acted as an independent party in relation to the operating firms, which made it possible to combine the role at group level. The group consolidation process was audited by the external auditor to prevent self control. It might be interesting to verify how, currently, the roles are combined within the AEX firms. This will be investigated as part of the empirical analysis of the internal audit functions within the AEX firms.
functions within the firm, such as compliance, risk management, revenue assurance and quality functions\textsuperscript{15}. The overview identifies a continuous focus on the reliability of (financial) information, supported by reliable automated systems. It is interesting to observe that the partner of management paradigm is leading, and the Audit Committee is not really considered a key stakeholder in 2001/2002. That was to change in subsequent years.

The third and final report describes the overall conclusions of a workshop with the main Dutch internal audit leaders at that time and it includes the opinion of five executives and two Supervisory Board members with respect to the role of internal audit (van Kuijck et al., 2003). The participants in the workshops conclude that the value proposition of internal audit relates to relevance, coverage, topicality and changeability with regard to business risk and processes. The key terms mentioned are multidisciplinary teams (to cover diversity of risk areas), independence, objectivity, professionalism, proactivity, innovation in audit approach, knowledge of management’s needs and a good relationship with management. These terms are in line with the IIA report in 1998, so nothing new there. On the other hand, little attention is paid to the questions of management's risk appetite and understanding of the business, although these seem to be relevant in providing an appropriate level of assurance, help management in risk and control areas and in its ability to innovate its approach. This match is not made and is also not highlighted in the report.

The interesting points that arose from the interviews with the executives and Supervisory Board members are the following: (1) the key role of internal audit is to provide assurance. Consulting is not seen as a key task for internal audit, although there is room for this if internal audit has the capability or as part of their natural advice role as the result of identified control deficiencies; (2) independence is not a precondition to perform the work; (3) internal audit is an assessor of or verifies control systems and should not take any initiative regarding, for example, restructuring activities. On the other hand, it is appreciated when internal audit identifies so-called weak signals of possible risks and/or control issues; (4) a proactive approach is appreciated but internal audit should not take over the management responsibility in solving issues; (5) the interviewees do not relate

\textsuperscript{15} Although these are marked as assurance functions, the risk management and compliance functions would probably be marked as management support functions in the current timeframe, and not immediately as assurance functions!
internal audit to being responsible for the audit of the reliability of the financial statement.

Overall conclusion of the three reports on the Professional Practices and Competency Framework of internal audit in the Netherlands is, that the developments from the IIA in the U.S. seem to be leading in the approach of the IIA in the Netherlands. These developments seem not solely based on requests from within a firm (Audit Committee, Management Board), or based on institutional or theoretical changes, but are also opportunity-driven. In the Netherlands, the implementation of the American IIA insights is limited mainly by the discussion on the dichotomy between financial and operational audit. This may well be due to the background of many internal audit functions, such as the background of the chief internal audit, the background team, its activities, and the view of Management Board’s and Audit Committee’s on their internal audit function.

2.3.3 Position papers

In April 2005, the Dutch chapter of the Institute of Internal Auditors (IIA) and the Internal Accountants’ chapter of the Royal Dutch Institute of Chartered Accountants (called INTAC) published a position paper on the role of internal auditors in the Netherlands. This position paper was in accordance with the standards of the international IIA and the International Federation of Accountants (IFAC).

This position paper\textsuperscript{16} contains sixteen points of view on correct conduct and the position of internal audit in the Netherlands (IIA et al., 2005: p 4-12).

1. It is the duty of the internal audit function to provide additional assurance on the effectiveness and the control of the business operations to the managing director and the management of an organization.
2. The task of the internal audit function is to evaluate and control the business proceedings by performing audits, reporting and advising on these

\textsuperscript{16} This position paper was released after the Dutch corporate governance code (DCGC) was published (2003) and includes more elements than the DCCG. However, a strong link with the ‘accountants’ within the IIA is also visible, specifically in relation to item 13 and 16. This goes beyond the requirements in the DCCG, even the 2008 version. This shows the strong influence of ‘accountants’ in the set-up of this position paper.
to responsible management and to the Audit Committee, answerable to the managing director.

3. The internal audit function is guided by the norms and standards of one or more recognized and authoritative professional associations in The Netherlands.

4. Sufficient expertise is available within the internal audit function.

5. The internal audit function develops and maintains a quality control system that continuously ensures that norms and standards of the professional associations are complied with.

6. The managing director of the organization appoints the head of the internal audit function.

7. After conferring with the Audit Committee the managing director will allocate the internal audit function’s tasks. These tasks are based on the risk profile of the organization and are determined in combination with the tasks of the external accountant.

8. The managing director\(^{17}\) shall lay down the responsibilities and duties of the internal audit function in an audit charter. After the Audit Committee has been informed by the managing director, he will also make these tasks known to the organization’s management. Arrangements of importance to the execution of the tasks are also laid down in this charter.

9. Internal audit will attend the meetings of the Audit Committee, as well as those of the Supervisory Board, at its invitation, along with the mandate, as necessary, to confer with the Chairman of the Audit Committee and/or the Supervisory Board.

10. Internal audit will promote the implementation of audit recommendations made, without affecting the impartiality of the internal audit advisory role.

11. Internal audit will periodically propose audit planning for consideration and approval by the managing director.

12. The Audit Committee will discuss the planning, realization and reporting of the internal audit function in the presence of the managing director and the internal auditor.

13. The officer commissioning the external audit will request the external accountant to pay special attention in his management letter to the performance of the tasks of the internal audit function.

14. One of the duties of the internal audit function is to judge the set-up and operation of specialized assurance functions.

\(^{17}\) The position paper includes an explanation (2005: p. 3) for the description of this function: The neutral term ‘managing director’ is used for the Chief Executive Officer as well as the Minister and/or Secretary General (SG), being the highest political or official head of a Ministry.
15. Taking into account their own specific assignments, the external accountant and the internal auditor will co-operate optimally.

16. The managing director of an organization decides to what extent the internal auditor will be involved in the financial audit. This involvement may imply that the internal auditor issues an internal auditors’ certificate.

This paper discusses familiar items such as function, expertise, positioning, overview, relationships with other assurance providers, the relationship with the external auditor and its certification role. Some new insights are included: Firstly, the position paper includes different kinds of audit (e.g. operational, financial, compliance and Health, Safety and Environment (HSE) audits) under the umbrella of internal audit, while in 1998 these audits were performed by different functions. Secondly, there is a statement on multidisciplinary audit teams. The new element relates to the inclusion of specialists from the business. This points to a new direction with a mix of expertise, outside the regular RA, RO, RE and RC areas. Thirdly, the position paper states the requirements of working in accordance with the norms and standards of one or more of the recognized and authoritative professional associations in the Netherlands, such as the Dutch Institute of Internal Auditors (IIA), the Royal Dutch Institute of Chartered Accountants (NIVRA) and the Association of Chartered Operational Auditors (VRO), the Dutch Order of Chartered EDP Auditors (NOREA) and the Dutch Order of Accountants-Administration-Consultants (NOvAA) (IIA-NL, 2005: 6-7). This could be a challenge, as they all have their own view and each covers a part of the overall internal audit activities. In addition, this limits the scope of available knowledge and experience, required for a multidisciplinary function – the required inclusion of specialists from the business and their knowledge, norms and standards may be inconsistent with using the norms and standards of the predefined associations. Fourthly, the roots of the internal financial auditor are still visible in the position paper and the issuing of an internal audit certificate. This is only possible for internal auditors who carry the post-nominal’s RA or AA with certifying qualification.

The Dutch IIA updated its position paper in 2008 with a further extension of the position and claimed added value and scope of internal audit activities in relation to the more formal position paper of 2005 (IIA, 2008). In this position paper, internal audit is linked to the so called three lines of defence model, i.e. management as the

18 The difference between the associations has decreased in 2011 as IIA and VRO, as well as NIVRA and NOvAA, have merged.
first line of defence; control/compliance/risk management etc. as a second line of
defence and internal audit as the third line of defence. The scope of work of
internal audit should be seen in comparison with the activities performed by
management and supporting functions, together with the level of automation of
basic control elements. This provides the opportunity for internal audit to build on
these activities and to perform activities in other areas. The main changes described
in the position paper relate to the extension of activities, including auditing project
and program management, assessing integrity and fraud prevention and related
social or soft control, assessing supporting functions such as HR and Marketing,
and finally, auditing the information with regard to the corporate sustainability
report. The first activities relate to risk areas, to weak spots in a control system,
where things could go wrong. The role of the internal audit in the corporate
sustainability reporting is not based on a risk perspective, but is of a more
facilitating nature and limits the cost of external audit.

2.3.4 Relationship with stakeholders

More recent publications cover the relation of internal audit and the Audit
Committee (IIA, 2008), the external auditor (IIA et al., 2009) and other
governance, risk and compliance (GRC) functions (IIA et al., 2010).

The publication regarding the existing relationship with Audit Committees in the
Netherlands covers interviews with Audit Committee chairmen and describes some
best practices (IIA, 2008). The report concludes that Audit Committee members
have a more intensive relationship with the chief internal auditor, also due to a
more direct reporting line, more frequent meetings and more involvement of the
(chairman of the) Audit Committee in the appointment, evaluation and dismissal of
the chief internal auditor. According to the Audit Committee chairmen there is
room for improvement in the area of reporting, contact outside formal meetings
and the use of internal audit as a front office to attract talent (talent pool function).
In addition, the report includes statements from Audit Committee members such as
... assign grades ranging from 4 through 9 to the internal audit functions ... and
Generally speaking, the results of the internal audit functions ... are acceptable
(IIA, 2008: p. 22), without clarification of the underlying meaning and elements of

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19 Although not marked as a line of defence, the Audit Committee and External auditor could also be
described as lines of defence. The origins of this three-lines-of-defence model are obscure; it didn’t
work during the recent financial crisis for the financial sector for which it was developed. So it should
be questioned if this model is fit-for-purpose or just another management fad.
improvement. This is a missed opportunity to detail what should be improved besides the general points mentioned earlier, because this may bring the function of internal audit to a next level instead of muddling through. The report also includes an interesting statement with regard to outsourcing, this not being an option for the Audit Committee members, and capacity that should be more flexible (i.e. during major change processes the audit capacity should increase).

The report on the relationship between internal and external audit reflects the status quo of relying on each other’s work to cover all relevant audit areas (IIA et al., 2009). The report mentions that the external auditor relies on the internal auditor’s work; however the external auditor would like to see more reciprocal reliance. The report intends to highlight the possibilities and best practices to align the work of external and internal audit. However, the report is written more from the perspective of the external auditor rather than that of the internal audit perspective or from a governance perspective. The report covers only a part of the perspective of internal audit, namely the part that covers the common scope of internal and external audit.

A last report regarding governance covers the results of the role of internal audit in the area of governance, risk and compliance (GRC) (IIA et al., 2010). The conclusion of the report is, among others, that internal audit is the spider in the web and has access to all parts of the firm. The main conclusions of the report are (IIA et al., 2010: p.4):

- The approach of the Internal Audit function to produce an assessment of the governance in an organization can certainly be professionalized more.
- Distributing GRC responsibilities among several functions results in better control of the organization.
- Risk management is still being developed and the internal audit function does not have a clear approach of how to evaluate it yet.
- The Internal Audit function still focuses too much on risk management processes and too little on the outcome of these processes\(^\text{20}\).
- The activities arising from legislation and regulation, also referred to as 'regulatory compliance', are increasing perceptibly and reinforce a rule-oriented culture to the detriment of a principle-based culture.

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\(^\text{20}\) This is an interesting suggestion and shows the further evolvement of the IIA/Nivra knowledge and understanding as in their 2008 report *Allies in Governance* they suggested focusing only on the design and functioning of risk management, seen also on the previous page of this study.
Overall, this report is a reactive response to a temporary phenomenon called governance, risk and compliance, without using a clear theoretical basis, without including a clear position and without including outlooks. Furthermore, the interpretation of the role of internal audit in it is very narrowly focused, and does not include a multidisciplinary view on the phenomena control in relation to a firm and its institutional context.

2.3.5 Study report Common Body of Knowledge (CBOK)

In 2010, the Dutch IIA published a report on the IIA Common Body of Knowledge (CBOK). It describes the main changes in scope with survey results from the IIA’s global internal audit survey. The table below is a consolidated overview on earlier research by Paape (2007) and the new figures of the 2006 IIA CBOK data published by IIA Netherlands (IIA, 2010b), to provide a longer period of comparison.

<table>
<thead>
<tr>
<th></th>
<th>Governance*</th>
<th>Financial audit</th>
<th>Operational audit</th>
<th>Compliance audit</th>
<th>IT audit</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>--</td>
<td>46%</td>
<td>32%</td>
<td>--**</td>
<td>12%</td>
<td>10%</td>
</tr>
<tr>
<td>1998</td>
<td>--</td>
<td>30%</td>
<td>51%</td>
<td>9%</td>
<td>--***</td>
<td>10%</td>
</tr>
<tr>
<td>2000</td>
<td>--</td>
<td>22%</td>
<td>45%</td>
<td>9%</td>
<td>16%</td>
<td>8%</td>
</tr>
<tr>
<td>2003</td>
<td>3%</td>
<td>30%</td>
<td>26%</td>
<td>13%</td>
<td>11%</td>
<td>17%</td>
</tr>
<tr>
<td>2006</td>
<td>6%</td>
<td>21%</td>
<td>27%</td>
<td>17%</td>
<td>12%</td>
<td>17%</td>
</tr>
<tr>
<td>2009 ****</td>
<td>8%</td>
<td>18%</td>
<td>27%</td>
<td>16%</td>
<td>13%</td>
<td>18%</td>
</tr>
</tbody>
</table>

Table 2.1: Division of activities and time spend

* = was not measured in 1991, 1998, 2000
** = not specified in 1991
*** = No IT included in 1998
**** = 2006 prediction for 2009

Paape already identified certain difficulties in comparing the figures between 1991-1998-2000. His problem with the figures was that no reference was made to IT
audit in 1998. Although the percentage for operational audits went up significantly (from 32% to 51%, falling slightly back to 45%) and the percentage for financial audits decreased from 46% to 30% and then to 22%, this might be because EDP audit was categorized under operational audit in the second study.

Furthermore, the study results of 2006 (covering 2003 figures and an estimate of 2009) show a huge decrease of attention for operational audits and even a decrease in IT audits, which is peculiar. It may be explained by the decrease in the hype surrounding operational audits, as discussed before. The decrease of IT audits can be explained by a more integrated operational audit approach, which also covers IT (application) control.

There is also a remarkable increase for the element financial audits in 2003. This may be explained by the Sarbanes Oxley regulation, which required more attention for financial audits. Paape (2007) mentioned this as well — it is here to stay and will not be completely absent from the activities of internal audit.

In addition, there is a new subject in the reports called governance, which is considered to be part of the internal audit activities. Section 2100 of the International Standards for the Professional Practice of Internal Auditing (Standards) describes governance in more detail (IIA, 2010a): The governance process relates to the following objectives:

- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and
- Coordinating the activities of and communicating information among the Board, external and internal auditors, and management.

The report does not clarify which specific activities internal audit needs to carry out to achieve good governance. A recent publication of the IIA Netherlands also mentions the governance element and it indicates increased attention to the provision of training for the Audit Committee, regulatory compliance assessment monitoring and corporate governance (IIA, 2010b). The concept of governance used in the report is a specific interpretation of the term governance, which is not based on the international literature on (corporate and internal) governance (e.g. Tricker, 1984 and Williamson, 1996).
A different description of governance, defined in a recent IIA Inc report, is: providing administrative support for the Audit Committee (Anderson, 2003: p. 33). If this refers to the final objective, it only covers the regular internal audit reporting, but under a new heading. The question is, whether this is confirmed by the directors of internal audit within AEX-listed firms who were interviewed in the empirical part of this research.

2.4 Research by the Institute of Internal Audit (1941-2010)

The global professionalization of internal audit started with the establishment of the Institute of Internal Auditors in the United States in 1941 (Brink, 1991; Courtemanche, 1991; Sawyer, 1996)\(^\text{21}\). In 1941, two internal auditors, Robert B. Milne and John B. Thurston, concluded that a new professional body focusing on internal audit was needed for further professionalization (Brink, 1991). The purpose of the Institute of Internal Auditors is described by one of its founders, Robert B. Milne in 1945 (Flesher, 1996: p. 1):

*The Institute is the outgrowth of the belief on the part of internal auditors that an organization was needed in the structure of American business to develop the true professional status of internal auditing... Although its roots are in accountancy, its key purpose lies in the area of management control. It comprises a complete intrafirm financial and operational review.*

This initial purpose of the Institute of Internal Auditors was more vision than reality. In practice, internal audit was still an accounting-related function with a strong link to the external financial auditors. The interpretation of the word *management control* could also cause some confusion as it is not consistent with main stream definitions of management control as defined by Anthony and/or Merchant (see chapter 4 for details on their definitions).

A next step in the professionalization of internal audit were the so-called Statements of Responsibilities of the Internal Auditor (Gupta et al., 1992; Sawyer, 1996). The purpose of this statement was to provide a general understanding of the

\(^{21}\) The need for a global professional institute became evident after chapters of the IIA spread from the United States to other countries. Currently, the Institute has around 96 institutes over the world. The institute of Internal Auditors is a recognized professional association with a bi-monthly internal auditing magazine, a certification program to Certified Internal Auditor (CIA) and many seminars and training opportunities, as well as its own research foundation with research on the history, developments and future of internal auditing.
objective, scope and responsibilities of internal audit. In the first statement in 1947
the emphasis was on accounting and financial matters. The early Statement of
Responsibilities of Internal Audit (1947) described internal audit as an independent
appraisal activity within an organization for the review on the accounting,
financial and other operations as a basis for protective and constructive service to
management. It is a type of control that functions by measuring and evaluating the
effectiveness of other types of control. It deals primarily with accounting and
financial matters, but it may also properly deal with matters of an operating
nature. (IIA, 1999b: p. 53)

Over the years the Statement of Responsibilities of Internal Audit (1957, 1971,
1976, 1981, 1990) was adapted and was finally integrated into the International
Professional Practices Framework in 2002. Between 1947 and 1971 the focus was
more on operational control than on financial and accounting matters. From the
1971 statement onwards, the scope of internal audit was focussed entirely on
operations and the words 'accounting' and 'financial' were eliminated. The financial
and accounting matters were seen as a part of the operations, and therefore did not
need to be made explicit, according to the IIA.

Another, more fundamental, change was the proposal for a new definition of
internal auditing (IIA, 1999b; Krogstad, Ridley, & Rittenberg, 1999): Internal
auditing is 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.

The premises of the new definition, explained in publications covering the main
changes (Chapman & Anderson, 2002; Krogstad et al., 1999), are:

1. Internal audit is not only characterized as an independent, but also as an
objective activity. This should enable an internal audit function to perform
engagements on behalf of management or a business unit which may not
be possible from the standpoint of independence but are possible in the
sense of taking an objective (verifiable) approach.
However, independence is also related to the organizational position of
Internal Audit. The IIA standards prescribe that internal audit must report
to a level within the organization that allows them to fulfil its
responsibilities. Ideally, internal audit should report functionally to the
Audit Committee, the Board of Directors, or any other appropriate
governing authority, and administratively to the Chief Executive Officer (CEO).

2. Internal audit does not necessarily need to be established within the firm, but may be outsourced to an external party. While the internal audit function has traditionally been seen as an internal activity, many firms have outsourced some or all of their internal audit activities. When internal audit is outsourced, it is mainly outsourced to its external auditor or another audit firm. (Carey, Subramaniam, & Chua Wee Ching, 2006). Since 1999 there has been discussion on outsourcing of internal audit, especially in relation to external audit. Most recently, a discussion focused on the company Rentokil, that outsourced the internal audit function to their external auditor (see also paragraph 2.6.4).

3. The new definition emphasizes that the scope of internal audit encompasses assurance and consulting activities. This is explained as internal audit being a proactive, customer-focused function, concerned with key issues in control, risk management and governance — including monitoring new projects — without losing sight of its independent, objective role. This shift in focus is also highlighted in the starting statement from Wayne Gretzky in the article from Krogstad, Ridley, & Rittenberg (1999): *I skate to where the puck is going to be, not where it has been.*

4. To remain viable, the new definition explicitly states that internal audit is designed to add value and improve an organization’s operations. Internal audit needs to be perceived as a contribution to an organization. This is an essential point and it is also interesting to see how this added value can be measured. The IIA does not expand on questions such as *How much value do internal audit services add?* *What costs are involved?* and *How to improve the effectiveness and efficiency of services rendered* (Paape, 2007). Most frequently used performance methods for the internal audit activity include 1) assessment by percentage of the audit plan completed; 2) acceptance and implementation of recommendations; 3) surveys/feedback from the Board/Audit Committee/senior management; 4) customer/auditee surveys from audited departments; 5) assurance of sound risk management; and 6) reliance by external auditors on the internal audit activity (Chenhall, 2003: p. 49).

5. Internal audit does not only focus on control or financial control, but its scope has expanded to risk management and governance processes, in order to help organizations accomplish overall objectives. It must reflect the organizational service drivers and the entire chain of value. This statement shows the shift from control to risk and governance. Attention to risk-based internal audit was initiated in the late 1990’s and described the link to business objectives instead of only financial statement related objectives (McNamee et al., 1998).
6. The last premise and, according to the IIA, the most valuable asset consists of being a standards-based profession, as the basis for crafting a documented, disciplined and systematic process that assures quality performance on internal audit engagements.

Again, as in 1945, this definition reflects changes that already occurred. However, it should be seen as guidance to a more influential role in the future as well. It is also a kind of mission statement for future direction, without clarification of the current status versus future prospects. However, to date the 1999 IIA definition and scope are still in use, the only change relates to the attention for the areas control, risk management and governance. In the global IIA studies of 2006 and 2010 the following key activities regarding internal audit are taken as starting point (Allegrini, D’Onza, Melville, Sarens, & Selim, 2011):

- Governance
- Operational Audit
- Regulatory compliance
- Financial Audit
- Risk Management

Control seems to be included in operational audit, regulatory compliance and financial audit. Interestingly, there seems to be no explicit attention for IT!? In the glossary of the 2010 CBOK studies the following definitions are provided (Allegrini et al., 2011: p. 73-76):

*Governance:* The combination of processes and structures implemented by the Board to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.

*Risk management:* A process to identify, assess, manage and control potential events or situations to provide reasonable assurance regarding the achievement of the organization’s objectives.

*Control:* Any 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.

*Compliance:* Adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.
How these definitions, formulated by the IIA, match with equivalent definitions in other academic fields remains to be seen. The definitions cover parts of definitions in academic literature, but do not use them accurately. The definition of governance and control, for instance, seem to be a mixture of the definition of corporate governance by Tricker (1984) and management control by Merchant (1998), but in the end the definition lacks accuracy. In the following chapters more accurate definitions will be presented and will provide more clarity.

The 2010 CBOK studies do not provide separate definitions of operational, compliance and financial audit, but only a general statement about assurance services: An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management and control processes for the organization. Examples may include financial, performance, compliance, system security and due diligence engagements.

An extensive global IIA study in 2006 and 2010 revealed the following key results and focus areas with regard to internal audit (Allegrini et al., 2011; Burnaby & Hass, 2009): A first conclusion was that there is limited theory to the reason why an internal audit function exists. The only explanation is the requirement by law (such as government decrees or parliamentary acts) or regulation (such as stock listing rules, central banking regulations) (Allegrini et al., 2011: p. 2). In the 2006 survey, 62% of the respondents indicated that the internal audit activity existed because of the requirement by law or regulation. The survey of 2010 shows an increase to 70% and an expected increase to 75% in the next five years.
In 2006, the respondents indicated the following audit activities as most important and less developed roles (Burnaby et al., 2009: p. 828):

<table>
<thead>
<tr>
<th>No</th>
<th>TOP 4 in 2006</th>
<th>Top 4 least performed activities in 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Fraud prevention</td>
<td>Executive compensation</td>
</tr>
<tr>
<td>2</td>
<td>Risk Management</td>
<td>Globalization</td>
</tr>
<tr>
<td>3</td>
<td>Regulatory Compliance</td>
<td>Environmental sustainability</td>
</tr>
<tr>
<td>4</td>
<td>Corporate Governance</td>
<td>Emerging markets</td>
</tr>
</tbody>
</table>

Table 2.2: Most and least developed internal audit activities 2006 (Burnaby et al., 2009)

In 2010, the respondents indicated the following audit activities as most important and less developed roles (Allegrini et al., 2011):

<table>
<thead>
<tr>
<th>No</th>
<th>TOP 5 in 2010</th>
<th>Top 5 least performed activities in 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Operational audit</td>
<td>Implementation of Extensible Business Reporting Language (XBRL)</td>
</tr>
<tr>
<td>2</td>
<td>Compliance with regulatory code (including privacy) requirements</td>
<td>Executive compensation assessments</td>
</tr>
<tr>
<td>3</td>
<td>Auditing of financial risks</td>
<td>Migration to International Financial Reporting Standards (IFRS)</td>
</tr>
<tr>
<td>4</td>
<td>Investigations of fraud and irregularities</td>
<td>Social and sustainability (corporate social responsibility, environmental)</td>
</tr>
<tr>
<td>5</td>
<td>Evaluating the effectiveness of control frameworks</td>
<td>Quality/ISO audits</td>
</tr>
</tbody>
</table>

Table 2.3: Most and least developed internal audit activities 2010 (Allegrini et al., 2011)

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22 It should be noted that the IIA survey results do not provide any indication of the proportion of working time spent on the key internal audit areas. Therefore, a comparison in division of time is not possible.
As there were differences in the questionnaires used in 2006 and 2010, a direct comparison of results is not possible (Allegrini et al., 2011). Nonetheless, the authors of the 2010 survey indicate that both operational audit and compliance audits continue to be important activities. Furthermore, the areas governance and risk management continue to be more important, besides the financial and operational audits that are expected to remain stable during the next five years.

Furthermore, the global IIA study from 2010 reports the following trend in the future of important attention areas (Allegrini et al., 2011):

- Corporate governance reviews
- Audits of the enterprise risk management process
- Reviews addressing linkage of strategy and firm performance (e.g., balanced scorecard
- Ethics audits
- Social and sustainability audits

These activities are linked to a perceived increase of importance of compliance with corporate governance codes and related implementation of control frameworks. The IIA study also reveals that there is gap between the expectations of management and those of employees of internal audit functions, and the authors suggest that there is a lack of shared vision or consensus on where the profession is going (Allegrini et al., 2011).

The IIA research and their suggestions for expansion of internal audit’s scope of work do not always seem to be theory-driven or demand-driven, but opportunity-driven. However, this approach also leads to semantics (new words for activities but no new content) and muddling through on old research questions which do not cover all relevant changes in the institutional context of firms and its environment.

### 2.5 Regulations Influencing Internal Audit

The question to be asked is whether the existence of internal audit and its scope of work are determined by exogenous forces, in particular the institutional or regulatory context of the firm. Therefore, to understand this question, some relevant changes in the institutional or regulatory environment of the firm will be discussed, applicable to multinational firms that form the scope of this thesis.

In 1997, the Dutch Committee on Corporate Governance (Peters Committee) issued the first corporate governance report. This report did not pay attention to the role of internal audit. In 2003, the Corporate Governance Committee (Tabaksblat
Committee) updated the recommendations made by the Peters Committee. The Tabaksblat Committee was initiated after the accounting scandals in the United States, Europe and the Netherlands. The Committee and its code were to provide a more detailed guide for listed firms to improve their governance (Corporate Governance Committee, 2003: p. 67). The Committee also provided principles regarding internal audit as a relevant function in the evaluation of the internal risk and control systems. The updated code of 2008 included additional principles regarding internal audit in relation to the Audit Committee. In the absence of an internal audit function, the Audit Committee has to assess and the Supervisory Board has to explain its recommendation in the Supervisory Board’s report (Corporate Governance Code Monitoring Committee, 2008).

The Dutch financial industry was one of the first to have regulations regarding the role of internal audit. Before the implementation of the Wet Financieel Toezicht (Wft) in 2007, the Dutch financial sector already had mandatory rules laid down in the Regeling Organisatie Beheersing (ROB). The rules stipulate the requirement of a permanent internal audit function to systematically test and evaluate the effectiveness of the organizational structure and control mechanisms (Paape, 2007). Besides the regular Dutch Corporate Governance Code, the Dutch Banking code of 2009 includes the requirement of an independent internal audit function who has a reporting line to the chairman of the Audit Committee (NVB, 2009). The banking code, like the IIA definition, addresses the scope of internal audit with a focus on the quality and effectiveness of the bank's system of governance, risk management and control procedures.

The approach of contemporary internal audit, risk and control in the Dutch environment can be traced back mainly to the U.S. and U.K. and in case of the financial sector to the Basel and Solvency Committees. The description will start with the highlights of the most influential regulations and committees in the U.S. in relation to the role of internal audit:

2.5.1 Foreign Corrupt Practices Act

As a result of the Watergate investigation (1973-1976), legislative and regulatory bodies started to pay attention to control of public listed firms (COSO, 1992). Separate investigations by the Office of the Watergate Special Prosecutor and the SEC revealed that a number of large U.S. firms had been making illegal political contributions and questionable or illegal payments to foreign government officials. The response to these investigations was the introduction of a bill that was enacted as the Foreign Corrupt Practices Act (1977). Although the main purpose of this act
was to eliminate payments by U.S. firms to foreign officials to assist a firm in obtaining business, its secondary purpose was to enhance control within U.S. firms (Flesher, 1996). The act required that public firms maintain a system of internal control (see 15 U.S.C. § 78m). These control systems should be sufficient to provide reasonable assurances that transactions are authorized and recorded to permit the preparation of financial statements that conformed to the generally accepted accounting principles (Brink, 1991). This created an opportunity for internal audit to broaden their scope of work to include the whole system of control besides the familiar accounting control (Courtemanche, 1991). The Act also led to an increase in the establishment of internal audit functions in the U.S. and to the growth of the size of existing internal audit functions. The Foreign Corrupt Practices Act has, therefore, also been nicknamed the internal audit full-employment act (Flesher, 1991).

### 2.5.2 Treadway Commission

By 1985, there was renewed attention for control after a number of business failures at savings & loans banks and alleged audit failures (COSO, 1992). The National Commission on Fraudulent Financial Reporting was created in 1985 by the joint sponsorship of the AICPA, American Accounting Association, FEI, IIA and Institute of Management Accountants (IMA), under leadership of Mr. Treadway. The main objective of the commission was to identify the causal factors leading to fraudulent financial reporting and to define recommendations for the future reduction of incidences (Treadway, 1987). The work of this commission resulted in the issuance of the Report of the National Commission on Fraudulent Financial Reporting which emphasized the significance of competencies and behaviour of management and employees, competent and involved Audit Committees and an active and objective internal audit function (Treadway, 1987: p. 11-12). The Commission emphasized the importance of the internal audit function in the entire financial reporting process and its coordination with the independent external auditor.

Based on the recommendations of the Treadway commission, a task force under the auspices of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission was set up to provide practical and broadly accepted criteria for establishing internal control and evaluation of its effectiveness. The purpose of the COSO committee was to provide a common understanding of internal control among all parties (corporate management, internal and external
auditors, legislators, regulators, academics and the general public) and to assist management to exercise better control over a firm (COSO, 1992: p. 98).

In 2001, the COSO Committee published the Enterprise Risk Management - Integrated Framework, which expands on internal control with an extensive focus on the subject of enterprise risk management (COSO, 2004). This framework is not intended to replace the internal control framework from 1992, but rather incorporates the internal control framework.

2.5.3 Sarbanes-Oxley Act

The Sarbanes-Oxley act was signed into law in July 2002 as a direct result of U.S. corporate failures, in which significant control failures were associated with fraudulent financial statements. This act defines a comprehensive set of requirements, intended to lead to improvements in the governance and control of public registrants in the U.S. Most familiar is the required executive responsibility for effectiveness of control infrastructures, the procedures for financial reporting and the quarterly certification of, and annual attestation to, the effectiveness of control infrastructures and accurate, complete and timely financial statements (Sarbanes-Oxley Act (SOX), 2002).

Although internal audit is not included in the Sarbanes-Oxley act, the law turned out to have great consequences for internal audit functions. The U.S. legislator took the setting of audit standards for the audits of public firms away from the AICPA, a private standard setter, and created a new body, the Public Company Accounting Oversight Board (PCAOB), to set the audit standards for public firms (Rittenberg & Miller, 2005: p. 3). The directions in the Audit Standard are based on the internal control framework established by COSO and caused this to be more widely known and applied.

The Sarbanes-Oxley act also has some limitations. The approach stresses on financial reporting. In theory, the COSO framework also identifies efficiency and effectiveness of operations and compliance with laws as objectives of control. These two objectives are less directly related to the presentation of and required disclosures in financial statements and, therefore, receive less attention.

Internal audit has played a significant role in most organizations’ compliance efforts during the first years of the Sarbanes-Oxley act, by supporting management with the relevant risk & control documentation and testing, including updates to management and Audit Committees (Rittenberg et al., 2005). After the
implementation of the Act, internal audit’s attention for the requirements of the Act returned to their assurance role only. However, it shows the strong linkage between internal audit and control for financial reporting as a basic building block of internal audit functions.

2.5.4 Listing standards of the NYSE

As a result of the corporate failures (like Enron, WorldCom) in the U.S., the New York Stock Exchange (NYSE) responded with new corporate governance and disclosure standards to enhance investor protection (NYSE, 2004). One of the standards' rules was the requirement for all publicly listed firms to have an internal audit function (section 303A). The requirements state that the internal audit function should have a clear reporting line with the Audit Committee to ensure that the oversight function is operating effectively. This standard reinforces the legitimacy of internal audit for large firms.

Besides the developments in the U.S., there have been developments in the U.K. that influenced the Dutch environment and the Dutch code of corporate governance (such as the comply or explain focus and attention for principles besides rules), although less direct than the U.S. points.

2.5.5 U.K. Combined Code

In 1992, the Committee on the Financial Aspects of Corporate Governance (under responsibility of Sir Adrian Cadbury) issued a report on corporate governance specifically relating to financial reporting and accountability. The committee wanted to achieve a balance between the essential powers of the Board of Directors and their accountability. The reason for the initiative to set up this committee was the concern about a perceived low level of confidence both in financial reporting and the related ability of auditors to provide assurance on the reliability of these reports and the safeguarding of assets (Cadbury Committee, 1992). These concerns were heightened by some unexpected corporate failures of major U.K. firm’s (e.g. Maxwell and Polly Peck).

The internal audit function is described as complementary to, but different from, that of outside auditors (paragraph 4.39 of the Cadbury Code). The committee recommends that firms establish an internal audit function to monitor the control system including procedures. Internal audit is seen as an integral part of a firm’s system of control, together with supervision by the Audit Committee.
The discussion on the scope of the description of control was clarified in the Rutteman Working Group in 1994. This working group decided that the scope of the published statement of a firm’s control could be restricted to financial control only (Rutteman Working Group, 1994)\textsuperscript{23}. The scope for reporting on control effectiveness in the U.K. changed from internal financial control in the Cadbury and Rutteman reports to internal control (financial, operational, compliance control) and risk management in the Turnbull report (principle D.2.1.) (ICEAW, 1999). This development is also visible in the scope of internal audit in the U.K. (Spira et al., 2002). Furthermore, the relationship between the Audit Committee and internal audit has been strengthened as well since the Smith report (Smith Committee, 2003).

\subsection*{2.5.6 Basel Committee and Solvency}

The Basel Committee has a strong influence on the European banking sector. Although it does not possess any formal supranational supervisory authority, it does provide standards, guidelines and best practices which are adopted by the European Commission and/or by local countries. In 2001, the Basel Committee issued its best practices paper \textit{Internal audit in banks and the supervisor's relationship with auditors} (the Internal Audit Paper). This paper highlighted the importance of internal auditors in banking organizations and the need for cooperation between banking supervisors and banks' internal and external auditors (Basel-Committee-on-Banking-Supervision, 2001). These guidelines are translated in the Dutch Financial Supervision Act (Wet op het Financieel Toezicht (Wft)) as referred to earlier in this paragraph. The same applies to the insurance firms that are overseen by Solvency (II), a set of rules and regulations of the European Union, among others to set a proper risk management and control system\textsuperscript{24}.

\textsuperscript{23} Over the years, the U.K. code of corporate governance is monitored and updated with new views (Hampel in 1998, Turnbull in 1999, Smith in 2003, Flint in 2005, etc).

\textsuperscript{24} For reference see \url{http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm}
2.6 Academic Research on Existence and Scope of Internal Audit

The understanding of the existence and scope of internal audit can also be increased by investigating academic research on this topic. Paape performed research on academic and professional publications between January 1994 and April 2005, concluding that academic literature on internal audit is limited (Paape, 2007). This chapter will build on Paape’s prior study. Articles and papers were collected via university databases, Academic and Business Source Premier and journal collections from JSTOR, Sage, Science Direct, SpringerLink and Google scholar.

Paape (2007) surveyed 30 journals over the period January 1994 to April 2005 and 204 articles (see Appendix II). He mentioned that most articles were part of only a few journals, such as Managerial Auditing Journal, Journal of Auditing and the Dutch Maandblad voor Accountancy en Bedrijfseconomie. This research will review the period of May 2005 to January 2011 and investigate themes covered by the articles.

From the new research can be concluded that internal audit is still not a subject in management-related academic journals, such as the Administrative science quarterly and Academic management review. The articles found are included in accounting and audit-related journals, such as Accounting Horizons, International Journal of Auditing and Managerial Auditing Journal (for details see appendix II). Furthermore, 62 articles that include internal audit as a topic were identified in the selected period25. On average, approximately 10 articles on the subject were identified in the selected period (2005 – 11, 2006 – 11, 2007 – 8, 2008 -5, 2009 – 14, 2010 – 10, 2011 – 3 up to January). Most articles on internal audit have been published in the Managerial Auditing Journal (27 articles) and International Journal of Auditing (14 articles). In some cases, additional journals have been taken into account as they cover articles of internal audit in the selected period (for details see appendix II).

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25 The difference in total in comparison to the earlier selection of Paape is related to his selection of articles in the Managerial Auditing Journal. Paape’s selection included all publications containing some reference to internal auditing. This thesis only includes articles which highlights internal audit in the title of the article. This limited the number of relevant articles substantially.
The following main themes resulted from the review on various articles:

<table>
<thead>
<tr>
<th>Topic</th>
<th>Description</th>
<th>Use of theories</th>
<th>Research setting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal audit existence</td>
<td>Articles describing factors driving the adoption and characteristics of internal audit functions and the identification of organizational drivers of internal audit effectiveness.</td>
<td>Agency theory, Institutional theory</td>
<td>U.S., Australia, Italy, Belgium, Ethiopia</td>
</tr>
<tr>
<td>Scope of internal audit activities</td>
<td>Internal audit practices and developments in scope of work (risk based, value added, compliance, etc.) and in relation to external influences.</td>
<td>Limited to audit references, no explicit theories</td>
<td>U.S., Middle East, Africa, Asia, Europe</td>
</tr>
<tr>
<td>Relationship internal audit and external audit</td>
<td>Most articles refer to reliance of external audit on internal audit from an external audit perspective. Furthermore, there is a link with fees and outsourcing.</td>
<td>Limited to audit references, no explicit theories</td>
<td>U.S., Australia, Jordan</td>
</tr>
<tr>
<td>Outsourcing of internal audit</td>
<td>Sourcing decisions on internal audit activities and the impact of insourcing and outsourcing.</td>
<td>Transaction Cost Economics, Resource-based view on the firm</td>
<td>U.S., Australia, Netherlands</td>
</tr>
<tr>
<td>Relation to and with Audit Committee and Management</td>
<td>Articles relates to the independence and objectivity of internal audit. Furthermore, the articles describes the association of Audit Committee oversight and the nature of internal audit activities</td>
<td>Limited to audit references, comfort theory (relates to agency theory)</td>
<td>U.S., Australia, Malaysia, Belgium</td>
</tr>
</tbody>
</table>

Table 2.4: Internal audit themes from academic magazines

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26 There were a few general articles on the compliance with the IIA standards across Europe, U.S. and Asia as well. These are not relevant for this PhD and will, therefore, not be discussed.
2.6.1 Internal audit existence

The first identified and key theme for this study concerns the purpose of existence and the effectiveness of internal audit. There are only a few studies that researched the existence of internal audit in the period May 2005 – 2011.

The first three articles explain the existence of internal audit as a monitoring mechanism to reduce agency costs (Carcello, Hermanson, & Raghunandan, 2005b; Goodwin-Stewart & Kent, 2006b; Sarens et al., 2006). The agency costs are caused by information asymmetry between executive and independent directors, but also between senior managers and division/business unit managers. Internal audit is seen as a complementary mechanism besides control by management to create a proper governance structure that limits agency costs.

Carcello et al. (2005) first established that since 2001, the number of firms with an internal audit function increased due to regulations in the U.S. (such as the requirements of the NYSE). Furthermore, they investigated the size of internal audit functions, associated with the following variables (Carcello et al., 2005b: p. 70):

- Size of firm;
- Leverage;
- Type of industry, e.g. firms operating in the financial, service and utility industries;
- Relative level of inventory;
- Size of operating cash flows and
- Role of the Audit Committee, e.g. in the review on the internal audit budget.

Overall, they conclude that the establishment of an internal audit function, their size and scope of work is explained by a firm’s risks, their ability to pay for monitoring, and their audit characteristics.

Sarens and Abdolmohammadi (2010) performed a similar study with a focus on the European (Belgian) setting. They found some conflicting results in comparison with Carcello et al, such as a positive relation between management ownership and the relative size of internal audit and a negative relation between the proportion of independent Board members and internal audit size.

Goodwin & Kent (2006) identified variables for the existence of an internal audit function, such as size, asset composition, industry (financial sector), strong risk
management, corporate governance (= existence Audit Committee and an independent (non-CEO) Board Chair). They also summarized earlier articles on the existence of internal audit, which support the use of the agency theory as framework for explaining the existence and scope of internal audit functions. A first reference is made to Wallace and Kreutzfeldt (1991) who laid the foundation with their research into the characteristics of firms with or without an internal audit function and who identified size (measured by revenue, assets and net income), profitability and cash flow, industrial competition, regulation, decentralization, competent accounting personnel and conservative accounting policies, strong management control and low error propensity as indicators for the existence, scope and size of internal audit functions. Carey et al. (2000) did not find the presence of internal audit to be associated with size, debt, or agency variables (the proportion of non-family management in the firm, and the proportion of non-family representation on the Board of Directors) at Australian family-owned firms. He concluded that the existence of internal audit as monitoring tool is viewed as substitute for, rather than as complementary to external audit. This conclusion should be seen in relation to the scope of the research — small family-owned firms, totally different from large, multinational firms.

Arena, Arnaboldi, & Azzone (2006) and Arena & Azzone (2007) use the new institutional theory as described by Meyer & Rowan in 1977 and DiMaggio & Powell in 1983 for the analysis of the existence and scope of internal audit functions in Italy. There are external forces that may lead to the choice to set up an internal audit function, e.g. laws and/or regulations, the choice of other organizations, consulting or professional bodies (Arena, Arnaboldi, & Azzone, 2006). The studies show a strong influence of regulations when they impose sanctions, which is the case with a listing on the New York Stock Exchange. Another finding was that successful firms with an internal audit function mimicked other firms, which were influenced by professional organizations (such as Big4 firms) or bodies (such as IIA).

Arena & Azzone identified the following additional reasons for management to establish an internal audit function: efficiency and effectiveness of business processes, identification and evaluation of enterprises’ risks, additional attention for reliability of financial information and safeguarding of firm assets (Arena & Azzone, 2007). Furthermore, their study suggests significant correlations between the adoption of internal audit and the size (large versus small), industry (bank and insurance) and affiliation to the IIA. Their study also identified certain reasons like
fear of increasing bureaucratic complexity, cost-benefit analysis or the size of the firm (being too small) to not set up an internal audit function.

Christopher et al. adds to the Italian studies that the existence of internal audit, in conformance with the institutional theory, is a social expectation and pressure since corporate scandals at stakeholders (Christopher, Sarens, & Leung, 2009). An internal audit function is seen as a control in the governance framework of a firm and should, therefore, be in place.

Sarens et al. provided questions for future research which will be kept in mind (Sarens et al., 2006): Does listing encourage firms to set up an IAF, or can the establishment of an IAF be considered as a part of the preparation for an IPO? Does the dispersion of operations have an impact on establishing an IAF; the more (less) dispersed the operations of an organization are, the more (less) the need to set up an IAF as monitoring mechanism? Do we wait for a critical evaluation of whether traditional IA activities are still able to meet the current needs of organizations? These questions, and especially the last question, will be explored further in the next chapters. A study of Van Peursem indicated that line managers in Australia often do not believe that internal audit has sufficient knowledge to be able to meet the needs of management and they do not take their advice into account (van Peursem, 2004). This leads to a negative reputation of the effectiveness of internal audit.

2.6.2 Scope of Services

The articles related to the scope of services can be further categorized in the area of general developments in scope (Allegrini, D’Onza, Paape, Melville, & Sarens, 2006; Cooper, Leung, & Wong, 2006; Hass, Abdolmohammadi, & Burnaby, 2006), the role in Sarbanes-Oxley assessments (Carcello, Hermanson, & Raghunandan, 2005a; Nagy & Cenker, 2007), consulting activities (McNamee et al., 1998; Mihret & Woldeyohannis, 2008), fraud (Coram, Ferguson, & Moroney, 2008). It is interesting to note that there is only one article on information systems in relation to internal audit, while an efficient IT-function is thought to be essential for the success of a firm.

In 2006, the Managerial Journal of Auditing published a series of articles on the development of internal audit in Asia, U.S. and Europe, which all capture the same high level observations with respect to arguments to establish an internal audit function; increasing complexity of business transactions, a more dynamic regulatory environment and significant advances in information technology have
resulted in opportunities and challenges for internal audit (Allegrini et al., 2006; Cooper et al., 2006; Hass et al., 2006). In addition, the articles show differences per region. For example, they show that in Asia (covering, among other, Malaysia and Australia), the perceived status and professional leadership of internal audit was quite limited around 2006 (Cooper et al., 2006). This is also due to a lack of a professional program, such as used by the IIA. The article on the development in Europe describes the changes in Belgium, France, Italy and the U.K. (Allegrini et al., 2006). The article does not provide a single overview on developments, as it mentions the different maturity in every country. However, in a more recent article, Arena and Azzone describe the development from traditional accounting and financial control, into operational control, risk management and corporate governance (Arena & Azzone, 2009). They describe the activities ranging from regular assessments of the design and operating effectiveness of a risk and control system and training management to facilitating the implementation of enterprise risk management. Furthermore, the element 'corporate governance' can be interpreted as supporting the Audit Committee and external auditors in their duties with regard to monitoring the internal risk and control system.

The article on the developments in the U.S. was influenced mainly by the shift towards a focus on compliance as a result of the regulations of the Sarbanes Oxley act (Hass et al., 2006). This shift is seen as a potential reputation risk, as internal audit can be stereotyped as a compliance police agent, which most firms had left behind in the 1980s. Other articles on the Sarbanes Oxley act (SOx) were published by Carcello et al. (Carcello et al., 2005a) and Nagy & Cenker (Nagy et al., 2007). Carcello et al. investigated changes in internal audit after the U.S. accounting scandals and concluded that they had led to increased internal audit budgets and more frequent contact with the Audit Committee. Nagy & Cenker support the finding of more budget and work for internal audit on one side, and the risk of damage to its professional status on the other, due to the focus on compliance-related activities. The literature from the IIA in one of the previous chapters shows that this concern was unfounded, as SOx has not taken over all time and resources of internal audit functions.

27 There is a reference to the Netherlands in the title of the article, but in the description there is no explicit attention for the state of affairs in the Netherlands.
Another development relates to risk-based internal audit, focusing on risks related to the objectives of a firm (Hass et al., 2006). This risk focus highlights areas like the IT environment, that is marked as increasingly important, but also the area of strategic alignment as part of adding value to management. In an article from 2010, the risk-based internal audit is described as a topic in development (Castanheira, Lima Rodrigues, & Craig, 2010). First of all, it describes the association between risk-based annual audit planning and private, large firms (especially in the finance sector). It concludes that internal audit has a more proactive role in the implementation of ERM in smaller firms. The latter underscores the development towards prevention-focused service, away from a sole control approach to a risk-based approach, that also leaves room for consulting services (Hass et al., 2006). This development is consistent with the IIA definition of 1999 that emphasizes value-added activities. Consulting services is a way to create added value, according to the IIA. There are some articles related to added value consulting activities. The articles describe the positive benefits in the sense of staff morale and the general standing of internal audit. In addition, the risk profile of a firm, the quality of strategic planning and marketing of internal audit influence the extent to which a consulting profile is attained (Mihret et al., 2008). Most common consulting activities concern risk management facilitation, project management, legislative compliance evaluations and contingency planning and disaster recovery evaluations and involvement in mergers, acquisitions and divestitures (McNamee et al., 1998).

These risk related activities increase the workload of internal audit and there is concern from chief internal auditors for higher risks of failure and risks with respect to independence for internal audit itself (McNamee et al., 1998). At an earlier stage, the debate on independence issues due to consulting activities was investigated by Meredith and Akers (Meredith & Akers, 2003). They concluded that the perceptions between CEOs and CAEs differed on this topic; CEOs prefer focus on assurance while CAEs preferred also involvement in consulting activities. This shows the gap between the demands from management versus the opportunity approach from internal audit functions.

Fraud

Prevention and detection of fraud as a task of internal audit is a returning topic. Coram, Ferguson & Moroney identified that firms with an internal audit are more likely to detect and report fraud (Coram et al., 2008).
IT audit

There is only one article to explicitly link internal audit with IT activities, while in other articles IT is mentioned as being a fundamental part of modern firms (Allegrini et al., 2006; Cooper et al., 2006; Hass et al., 2006). The study verifies the scope of activities regarding IT and concludes that the internal audit focus is primarily on traditional IT risks and control, such as IT data integrity, privacy and security, asset safeguarding and application processing (Abu-Musa, 2008). Other elements, such as competitive disadvantages, wrong IT selection, privacy violations and business interruption, are given little or no attention, according to the study.

2.6.3 Relation internal and external audit

All articles that link internal audit to external audit are written from the point of view on external audit, discussing the question whether and how external audit can rely on internal audit. The background of the discussion relates to leveraging experience and reducing duplication of work, in effect the cost of external audit (Glover, Prawitt, & Wood, 2008; Munro & Stewart, 2010; Suwaidan & Qasim, 2010).

The reliance on an internal audit function from the point of view of external audit is determined by the following factors: objectivity of the internal auditor, competence and work performance in relation to financial audit related activities (Desai, Roberts, & Srivastava, 2010). Objectivity seems to be the most essential factor, followed by competence and work performance (Desai et al., 2010; Suwaidan et al., 2010). In addition, the actual reliance is also based on the expectations of litigation and regulatory costs. In case these are high, there is a higher probability of no reliance. In addition, Glover et al. (2008) found that external auditors are more willing to rely on the work of internal auditors when they perform objective tasks, as opposed to subjective tasks. This is also supported

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28 Desai, Roberts & Srivastava (2010: p. 538) included the definitions (cited below) of objectivity, competence and work performance in their article: competence was defined as the educational level and professional experience of the internal auditor and other such factors. Objectivity was defined as the organizational status of the internal auditor and organizational policies affecting the independence of the internal auditor. Work performance was defined as the assessment of internal control, risk assessment and substantive procedure performed by the internal auditor. They have taken the definitions from SAS No. 65 (AICPA 1991).
by Munro (2010), who investigated the impact of consulting services by internal audit and the negative influence of this on the willingness of external auditors to rely on the work of internal audit. Another study reveals that client pressure can significantly increase the willingness of external auditors to rely on internal audit, especially in case significant non-audit services are provided (Felix, Gramling, & Maletta, 2005).

In addition, there are some articles investigating whether internal audit involvement in external audits increases the effectiveness of external audits (Lin, Pizzini, Vargus, & Bardhan, 2011; Prawitt, Smith, & Wood, 2009). They prove that external auditors are more likely to detect material weaknesses in the financial statement when they coordinate their efforts with the IAF. Furthermore, internal audit plays a relevant role in the prevention and detection of material weaknesses in the financial statement of a firm.

Another related topic is the relationship between the reliance of external on internal audit and the level of external audit fees. The economic benefits of coordination of and reliance on work of internal audit (e.g. lower fees) are recognized in several studies (Glover et al., 2008; Munro et al., 2010). Some others investigated the fees in relationship with the existence of internal audit and the attention for higher quality external audit. In this relationship, the external audit fees were higher when firms had an internal audit function and were committed to strong corporate governance, preferring good quality external audit (Goodwin-Stewart & Kent, 2006a; Singh & Newby, 2010).

Finally, one article took a broader perspective and investigated the process of professionalization of internal audit versus external audit in Denmark. The study indicates that external audit maintained an intellectual jurisdiction over internal audit by controlling its knowledge base through monopolizing the educational system, thus preventing Danish internal audit from obtaining a distinct jurisdiction of its own (Arena & Jeppesen, 2010). The same issue applied to the Netherlands, although that situation has been resolved by setting up a separate course system for the education of internal auditors at a number of universities that is independent from the educational system for external auditors, and by separating the IIA from the NIVRA.

### 2.6.4 Outsourcing internal audit

Academic and professional internal audit literature with respect to outsourcing of internal audit activities has two sides. On one side it is argued that in-house internal
auditors have more commitment and in-depth firm-specific knowledge (Carey et al., 2006). On the other side, the proponents of outsourcing emphasize the external providers' (usually a public accounting firm) specialist expertise, flexibility, and cost-effectiveness (Speklé, van Elten, & Kruis, 2007). Research shows that the group affiliation bias needs to be taken into account; Gramling and Vandervelde's study of internal audit objectivity with a group of internal and external auditors showed that both groups were in favour of their own flavour (Gramling & Vandervelde, 2006). The same conclusion is reached by Glover et al. who concluded, based on an experimental case, that external auditors will sooner rely on the work of outsourced rather than in-house internal auditors when the inherent risk is high (Glover et al., 2008).

When a firm outsources its internal audit, it is mostly outsourced to the firm’s external auditor (Carey et al., 2006). Worldwide, this rate/percentage may have changed due to the Sarbanes-Oxley Act (Sec. 201g), which prohibited the outsourcing of internal audit services to firms’ external auditors (Sarbanes-Oxley Act (SOX), 2002). This change in regulation was motivated by the belief that this outsourcing creates an economic bond between external audit firms and their clients, thus compromising the ability of the external auditor to take strong stands against misleading or fraudulent financial reporting (Prawitt, Sharp, & Wood, 2010: p. 1). However, the SOx rules do not prohibit outsourcing internal audit activities to parties not being the external auditor of the firm.

The transaction cost economics (TCE) view on Williamson is commonly used to explain the outsourcing decision of internal audit (Carey et al., 2006; Speklé et al., 2007). They explain the background of TCE as being the transaction costs related to factors such as uncertainty, frequency of activities and asset specificity (Carey et al., 2006; Speklé et al., 2007). Carey also links outsourcing of internal audit to the more strategic resource-based view on the firm, which focuses on core business activities and exploitation of competencies based on knowledge and expertise, rather than on channeling resources to non-core activities (Carey et al., 2006). Carey also makes a reference to Rittenberg and Covaleski: They concluded that external audit firms promote assurance services relating to internal audit activities as their core competence, while this is just a supporting mechanism within a firm (Rittenberg & Covaleski, 2001).

Speklé and Carey’s empirical studies found that asset specificity (in the sense of specific knowledge) is significantly associated with the sourcing decision on internal audit activities (Carey et al., 2006; Speklé et al., 2007). They also found the variable frequency to be significantly associated with insourcing an internal
audit function, especially in case of large firms and firms that use internal audit on a frequent basis. Furthermore, they noted that traditional services of financial statement audit and compliance audit were outsourced, while other areas were kept in-house. However, the research of Paape did not support these outcomes, as it did not find significant relationships regarding asset specificity or information asymmetry (Paape, 2007). Paape suggests that these factors are more predictive for internal audit’s size.

In 2009, the outsourcing by Rentokil of the internal and external audit work to KPMG initiated a discussion, starting with an article in the Financial Times (Hughes, August 3 2009 ). In the Netherlands, discussions started as well and were published in the *Maandblad voor Accountancy en Bedrijfseconomie*, led by Marcel Pheijffer (Pheijffer, 2009). The discussion is primarily related to the perception of independence. This is in line with additional studies by, for instance, Hill, who shows that Board members do not perceive the outsourcing of internal audit to the external auditor as problematic, as long as separate members of the staff of audit supplier work on the two engagements (Hill & Hoskisson, 1987). Pheijffer also highlighted the recent study by Prawitt, who showed that outsourcing internal audit work leads to an even lower accounting risk compared to any other outsourcing arrangement, or compared to the in-house internal audit (Prawitt et al., 2010). The overall conclusion is that more research is needed to get a clear discussion and picture. This may also be accomplished by making the necessary differentiations in the outsourcing activities. Abbott et al. distinguish different outsourcing activities, more specifically routine versus non-routine internal audit activities (Abbott, Parker, Peters, & Rama, 2007). The first may lead to economic bonding, while this may not be the case for non-routine tasks that are nonrecurring, specialized activities. Their main conclusion is that Audit Committees have the ability to monitor the sourcing of the firm’s total internal and external audit coverage, while simultaneously exhibiting concern for external auditor independence.

### 2.6.5 Relation with Audit Committee and Management

The IIA describes internal audit as one of the organizational cornerstones of corporate governance (Holt & DeZoort, 2009; Stewart & Subramaniam, 2010; Strand Norman, Rose, & Rose, 2010). The other organizational cornerstones are management, the Audit Committee and the external auditor. The articles in the selected timeframe concerning the governance of internal audit mostly deal with the question of independence, meaning that internal audit must be free to report findings, the reporting activities are not subject to any influences and internal audit
is to be professional to be able to form unbiased opinions (Ahmad & Taylor, 2009; Christopher et al., 2009; Holt et al., 2009; Strand Norman et al., 2010). Specific elements such as the relationship with management, the relationship between internal audit and the Audit Committee, fraud, and reporting outside the firm are covered.

Holt et al describe that internal audit functions are seen as a crucial function to stem fraud and abuse and to prepare accurate financial statements by focusing on the control of the financial reporting process (Holt et al., 2009). The importance of internal audit for outside stakeholders is mostly related to the prevention of fraud and/or the detection of fraudulent activity (Marden, Holstrom, & Schneider, 1997; Strand Norman et al., 2010), based on internal audits' perceived intimate knowledge of the organization and processes. Also, the existence of an internal audit function is perceived as an advantage, to prevent losses associated with fraud. Holt et al. even suggest firms to consider providing an internal audit report to external stakeholders, to provide additional transparency (Holt et al., 2009). Their survey revealed that this report increases investors' perceived oversight effectiveness and confidence in financial reporting reliability.

Independence in the sense of objective and professional functioning has been studied from different angles. One angle is the influence of incentive compensation or stock ownership on planning decisions, which resulted in the conclusion that internal audit in the study was not impaired by that (Marden et al., 1997). O'Leary and Stewart's study shows that the existence of an effective Audit Committee had limited impact on internal audits’ ethical, objective decision making (O’Leary & Stewart, 2007). Ahmed et al clarified that independence is sometimes inflicted by ambiguity in the exercise of authority, time pressure, conflict between management and professional requirements and internal audit’s personal values (Ahmad et al., 2009). Furthermore, Sarens and De Beelde found that senior management’s expectations significantly influence internal audit planning and that their support is critical to the success of internal audit within a firm (Sarens et al., 2006). Van Peursem found that a close relationship with management can put their independence at risk, however, the interviewed respondents noted that they were conscious that they had to report to higher authorities, if necessary (van Peursem, 2004).

Other articles described the independence in the sense of accessibility of the Audit Committee. A general assertion and investor concern is the importance of a primary reporting line away from management and to the Audit Committee to prevent possible problems associated with internal auditors’ conflicts of interest.
Christopher et al. (2009; Holt et al., 2009; Stewart et al., 2010; Strand Norman et al., 2010). Christopher et al. (2009) found some independence threats in their Australian study, that varied from a CEO/CFO being responsible for appointing, dismissing and evaluating the head of internal audit without any role in this process for the Audit Committee (i.e. one-quarter of the firms), to a more general one of internal audit being a training ground and stepping stone for future managers. There is a risk that internal audit may not operate objectively when they depend upon their auditees for future career moves.

Strand Norman et al. found that internal auditors perceive more personal threats reporting high (fraud) risks directly to the Audit Committee, as against to management (Strand Norman et al., 2010). This finding runs counter to the anticipated benefits of direct reporting to the Audit Committee. The background of this fear is the investigated internal auditors' perception of overreaction by the Audit Committee, and subsequent management reprisals to internal audit. Their study shows that internal auditors believe that information is filtered through management, regardless the reporting line and the participating internal auditors do not prefer cutting off that line of communication with management.

Sarens et al. focused on the reason why internal audit adds value to the Audit Committee (Sarens et al., 2006). Their literature review and case studies illustrate that internal audit is a source of comfort to Audit Committees, especially in the domain of risk management and internal control. Comfort and discomfort are related to the level of information asymmetry between the Management Board and the Audit Committee. They illustrate that internal audit can provide comfort by involving the Audit Committee in the audit plan, providing reports and presentations, together with interpersonal and behavioural skills of internal audit as part of the informal contacts with Audit Committee members.

There is also attention for the discussion in relation to internal audit and serving two masters (Abbott, Parker, & Peters, 2010) with on one side the Audit Committee wanting to cover its litigation and reputation concerns, resulting in a focus on financial statement-related control since those are likely to reduce the incidence of financial misstatement; and on the other side management, who may prefer a broader perspective with more focus on operational audits. The study shows that Audit Committee oversight is positively associated with larger percentages of internal audit hours being allocated to control activities. However, the study also shows that many Audit Committees have little oversight of internal audit. Furthermore, there seems to be a balance of allocation of resources to
evaluation of control in relation to the financial reporting process and to other kinds of operational audits and consulting activities. Note that these results should be seen in the context of firms who have to comply with SOx, and as such may have a more distinct focus on the internal control in relation to the financial reporting process.

2.7 Concluding remarks

This review on literature on the origin and development of internal audit from different angles resulted in some interesting observations and conclusions.

The first conclusion is that internal audit function has its roots in accounting and financial audit. It was initiated to verify and to prevent bookkeeping errors and inaccuracies, as well as fraud and corruption. Internal audit activities were positioned within the accounting function and there was a strong relation with the external auditor. The main focus of internal audit functions was to audit the control with respect to financial reporting. Furthermore, the need for an internal audit function is related to the size of a firm. Since the 19th century firms became larger, with widely dispersed geographical locations and limited managerial ability to monitor all operations. Internal audit was initiated as a monitoring function, in addition to management supervision and controlling functions.

The second conclusion is that internal audit functions in the Netherlands were initiated to perform financial auditing activities as in the US. Both internal and external auditors had the same education and the same technical skills. Compared to other countries, internal audit in the Netherlands had a more specific role in the financial statement process, because of the possibility to issue an internal statement on the financial statement. Over the years this has changed, and in particular in the 1980s, many internal audit functions changed their role to a mix of financial and operational audit.

The third conclusion is that developments from the IIA in the U.S. seem to be leading in the IIA approach in the Netherlands. The implementation of the IIA insights in the U.S.A. is mainly limited by the discussion in the Netherlands on the dichotomy between financial and operational audit. This may well be due to the background of many internal audit functions, such as that of chief internal audit, the educational background of the team, its activities, and the views of the Management Board and the Audit Committee on their internal audit function.

A fourth conclusion is that the U.S. IIA research and its suggestions for expansion of internal audit’s scope of work do not always seem to be theory-driven or
demand-driven, but opportunity-driven. However, this approach also leads to semantics (new words for activities but no new content) and muddling through on old research questions (e.g. CBOK) which do not cover changes in the nature of the firm, its business models and the institutional context of a firm.

A fifth conclusion is that regulatory and legislative changes are an important reason why internal audit functions exist within some firms. Some regulations, such as the New York Stock Exchange corporate governance standards, but also regulation in the financial industry, require the existence of an internal audit function. This regulation institutionalizes the existence of internal audit functions within firms. However, the regulatory context, in response to a number of affairs, has regressed to a narrow view of control, mostly to the reliability of the annual report.

A sixth conclusion relates to the limited and narrowly focused academic research on internal audit. The subject of internal audit is mostly published in accounting and audit-related journals, and not in management-related academic journals. A limited number of articles use theories as background for their study. Three different theories are applied most often: the agency theory, the institutional theory and the transaction cost economics. They relate to the question why an internal audit functions exists and to the choice of in- or outsourcing the activities. Other articles cover the relationship with external audit. All these articles have been written from the external audit point of view, covering the question how external audit can rely on the work of internal auditors. There is also attention for the growing strength in the relationship of the Audit Committee and internal audit, which is also supported by external investors. The articles show discussion with respect to the allocation of resources as well, resulting from serving two 'masters'. While management seems to require assurance and consulting services from internal audit in the broad field of risk management and control, the Audit Committee mainly wants assurance on financial reporting risks and control, a proper tone at the top and possible investigations on fraud. A final observation is that although IT is mentioned as being an essential part of modern firms, especially for management accounting information systems (E.g. SAP, Oracle and other ERP-systems) and, therefore, expected to get attention in articles, this is not reflected in the articles published in the reviewed journals.

The overall final note of this chapter concerns the limited number of changes in the field of internal audit since the new IIA definition in 1999, neither initiated from its professional organization (IIA), nor from academic research. The only change is in the regulatory environment that positioned internal audit functions in the area of
corporate governance requirements after several corporate failures in the period from 2004-2006, but silence reigned during the financial crisis of 2008-2010. Furthermore, internal audit functions are closely related to external auditors in the governance requirements. The question is how much the internal audit profession has evolved or that they adhere to the frequently quoted epigram _plus ça change, plus c'est la même chose_...