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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6. Assessing the scope of Dutch internal audit

6.1 Introduction

Internal audit has been a growing occurrence in business supported by the establishment of the global Institute of Internal Auditors (IIA) in 1941 and IIA’s aim to make internal audit an embedded profession the world over. Internal audit within Dutch public firms emerged during the late 1930s, e.g. in Philips’ Gloeilampenfabrieken N.V., now Royal Philips Electronics and the Dutch Railways (Nederlandse Spoorwegen), as a result of internationalization and decentralization (Smith Committee, 2003). Ratliff concluded 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 et al., 2002: p xi). A recent study by the Institute of Internal Auditors (IIA) on the characteristics of internal audit suggests unprecedented growth opportunities due to advances in technology, the expansion of communication capabilities and the increasing complexity and sophistication of global business operations (Alkafaji et al., 2010).

However, these discussions do not clarify internal audit’s required scope of work. The Dutch Corporate Governance Code (DCGC) fails to provide sufficient criteria with respect to a firm’s effective system of control (Strikwerda, 2012) and subsequently fails to provide a framework for control from which internal audit functions could conclude their role, activities and its contribution. The DCGC limits itself to (internal) risk management and to control systems as needed for the annual report only, suitable for the size of the corporation (Corporate Governance Code Monitoring Committee, 2008). The DCGC requires a firm to expand on the kind of framework or criteria used as internal risk management and control system, with a reference to the COSO framework of internal control. This does provide some direction in the element of control. Although COSO has defined internal control in a broad sense, it apparently seems to work with the old rational, closed system paradigm and still focuses strongly on financial reporting and audit (Renes, 2002; Williamson, 2007). There is no explicit reference to a theoretical foundation within the COSO report. Although the COSO report includes literature references to Porter, Beniger (COSO report 1992) and to Tversky & Kahneman (COSO report 2004), which suggests a broader focus than financial reporting, the theoretical concept of these authors does not materialize in the COSO concept. Also based on
the discussions in chapter 3 and 4 it can be concluded that the COSO report misses quintessential elements or aspects to be able to provide a judgement on the effectiveness and completeness of a comprehensive control system of a firm.

The DCGC also limits the internal risk management and control systems to the requirement of a reasonable assurance that the financial reporting does not contain any errors of material importance (Corporate Governance Code Monitoring Committee, 2008: p. 14). This suggests that where auditors base themselves on corporate governance codes, they limit themselves to a narrow view on control.

As discussed in chapter 2, the main areas of attention of internal audit in the Netherlands are financial, operational, compliance and IT audit (IIA, 2010b). A new area is governance. An international IIA study in 2010 supported this Dutch scope with the following exceptions: they also included investigations into fraud and irregularities, and an evaluation of the effectiveness of control frameworks (Allegrini et all, 2011). The latter activity seems to specify the framework that could be used during audits, but does not provide new insights into the coverage of control elements. In addition, it does not match with the opening statement that internal auditors must be prepared to audit virtually everything. Paape already mentioned that IIA’s broad definition and statement are a source of vagueness leading to an expectation gap in practice (Paape, 2007).

Reading through some of the 2010 annual reports of AEX firms, words such as quicken the pace of transformation, transformation of portfolio, undergo significant transformation, changing global market environment, introduction of a new strategy, setting up a shared service centre, change the structure of the firm, align organization to better respond to the needs of customers describe an interesting broad environment for internal audit to work in and to provide assurance for. Are these areas also part of internal audit’s scope?

Therefore, this chapter will establish the following research question: How does the actual scope of work of internal audit functions of AEX listed firms in the Netherlands match with a broader, multidisciplinary view on the control system of a firm?

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Governance as an object of internal audit is defined in a recent IIA Inc report as providing administrative support for the Audit Committee (Anderson, 2010: p. 33). This seems to cover the regular internal audit activities and the regular reporting line. Besides a new word it does not seem to cover the area of governance from a content perspective.
An important element of the empirical research is to discuss possible differences between the theoretical explorations of internal audit and the control system of the firm as set out in chapter 4. It is assumed that they all have the same view on the elements of control and the scope of internal audit. The empirical explorations and discussions of Dutch AEX listed firms lead to more clarity on the contributions to and limits of internal audit in the control of a firm. This should answer the following question: *What explains possible differences between the internal audit functions’ scope of work and the theoretical model for control and what are or should be the consequences of these differences?*

This empirical part of the study will contribute to the theory of internal audit by comparing the developed multidisciplinary framework with the current Dutch internal audit practice at listed firms.

### 6.2 Theoretical framework

As discussed in chapter 4, cybernetics is the formal study of control. Cybernetics is defined as the science of communication and control in both machines and living beings (Ashby, 1956; Wiener, 1950). Management control researchers use cybernetics mainly from a closed system perspective (Anthony, 1995; Flamholtz, 1996), contrary to the open nature of cybernetics itself. Their emphasis relates to processes and the monitoring of information to ensure that processes behave within acceptable parameters. This closed perspective leads to a focus on internal processes and maintenance of the status quo and, where required, improvement of the standards, but lacks attention for the external environment.

Cybernetics itself has an open character (Beniger, 1986). This also applies to firms that can be described as information-driven constructions and that compete with their rivals and need to remain aligned with their changing environment, to adapt in order to remain alive (Williamson, 2007). This broader perspective, beyond the boundaries of an organization, increases the scope of uncertainty (Williamson, 2007). This view on control implies a broader view on the function of (management) control in the firm view beyond the limited scope of control as implied by codes for corporate governance. It requires attention for new areas, such as *adaptation* of goal-oriented organizations to variation and change in external conditions and *reprogramming* less successful goals and processes while preserving successful ones.
Based on the above, this study identified three levels of possible problems for control in line with Beniger (1986):

<table>
<thead>
<tr>
<th>Levels</th>
<th>Descriptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintaining the status quo</td>
<td>Maintaining an organization, in absence of external changes</td>
</tr>
<tr>
<td>Adapting</td>
<td>Adapting goal-oriented organizations to variation and change in external conditions</td>
</tr>
<tr>
<td>Re-programming</td>
<td>Reprogramming less successful goals, programs and processes while preserving successful ones</td>
</tr>
</tbody>
</table>

Table 6.1: Three levels of control according to Beniger (1986)

The cybernetic control processes are programmed on different levels within this hierarchy. The most basic cybernetic control process relates to administrative organization on process level (also called AO/IC in Dutch or accounting information systems). Traditionally, the internal auditor has not worked at all levels of the organization. Most authors in the field of internal audit focus on the control measures within operational and financial processes (Sawyer, 1996; Spira et al., 2002). This approach gives consideration to standards (such as authorization, compliance, accounting and safeguarding assets), assesses business transactions by following transactions all the way through the firm’s processes and provides assurance on the level of achievement of control objectives and operating effectiveness of standards. Internal audit is an additional monitoring activity besides the regular control performed by management.

At a higher level, cybernetic control is related to achieving several objectives for an entity of a firm up to the level of the firm. Cybernetic systems at still higher levels relate to control processes of a firm in relation to other organizations. These two higher levels are also being referred to as ‘management control’ (Anthony, 1995; Giglioni et al., 1974; Mautz et al., 1981; Merchant, 1982) and strategic control (Goold et al., 1987; Ittner & Larcker, 1997; Kaplan et al., 2008; Langfield-Smith, 1997; Simons, 1995).

Each higher level of system analysis shows management control concerned with a wider range of uncertainties (Williamson, 2007). As mentioned in the cybernetic view, a fundamental aspect of maintaining control is determined by information;
objective setting (goal information), value hierarchy of different patterns and preferences (axiological information), measuring facts (material information), interpreting and making sense of internal and external information (eidetic information), the cause-effect analysis (effect information) and creating information out of data (pragmatic information) (Garfinkel, 2008; Strikwerda, 2010; van Peursen et al., 1968)

Programming can be seen as encoded information, which must include both the goals toward which a process is to be influenced and the organization, procedures and systems for processing additional information toward that end (Beniger, 1986). Control, therefore, is closely related to programming of both individuals/groups as in computer programming.

Internal Audit requires practical principles of control of the firm in order to be of added value to them as well as to the firm. As discussed in chapter 4, extended research in management and management control shows that a comprehensive view on control is a mix of more traditional accounting control (such as budgets and financial measures), administrative control (such as organizational structure and governance systems) and socially based control (such as values and culture). The control elements of this comprehensive view are following:

- Mission
- Values
- Vision
- Strategy
- Organizational Structure
- Leadership
- Learning & Adaptation
- Performance Management & Monitoring
- Information & Communication

These elements of control will be taken into account during this empirical investigation in relation to Beniger’s three levels of control. The COSO model and its attention areas (such as internal environment and control activities) will not be used as its wording is mainly used within the audit world, but not by management.
However, a link will be made to the COSO categories of entity objectives as these provide a good opportunity to maintain a link with the framework commonly used and referred to by internal auditors (COSO, 2004: p. 21):

- Strategic objectives relating to high-level goals, aligned with the entity’s mission
- Operations objectives relating to effective and efficient allocation of the entity’s resources\(^{67}\)
- Reporting objectives relating to the reliability of information
- Compliance objectives relating to compliance with applicable laws and regulations

The effect of these objectives on this research is that separate attention will be paid to processes, financial and non-financial reliability of reporting and compliance. The objective strategy is already specified in the management control elements.

**6.3 Methodology of research**

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

The research sample is selected from the AEX firms of the NYSE Euronext. These firms have been selected on the premise that the AEX covers the Dutch leading multinational firms that are expected to be large, complex, multinational firms and operate in a competitive environment which creates a challenge for control of the firm.

A further premise is that AEX firms have an internal audit function, which is less often the case with AMX and AScX listed firms. The AEX firms without an internal audit function are not included in the scope of this research. The final

\(^{67}\) This definition uses an old resource configuration as it should cover the objective function of operational entities and the process of resource allocation.
premise is that the different AEX firms cover multiple industries and therefore allow a broad view to be generated.

The following firms have been selected and invited (see appendix IV and VI) for this research, based on the above criteria/premises:

<table>
<thead>
<tr>
<th>Aegon</th>
<th>Fugro</th>
<th>Shell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ahold</td>
<td>Heineken</td>
<td>SBM offshore</td>
</tr>
<tr>
<td>AkzoNobel</td>
<td>ING Group</td>
<td>TNT</td>
</tr>
<tr>
<td>ASML</td>
<td>KPN</td>
<td>Tom Tom</td>
</tr>
<tr>
<td>Boskalis</td>
<td>Philips</td>
<td>Unilever</td>
</tr>
<tr>
<td>DSM</td>
<td>Randstad</td>
<td>Wolters Kluwer</td>
</tr>
</tbody>
</table>

Table 6.2: Overview on AEX firms in scope for semi-structured interviews

Three AEX firms (BAM, Corio and Wereldhave) have not been selected because their 2010 and 2011 annual reports mention that they do not have an internal audit function.

Furthermore, four AEX firms (Arcelor Mittal, Air France KLM, Reed Elsevier and Unibail Rodamco) have not been selected because their head-office is not in the Netherlands and the head of internal audit was not in the Netherlands to be interviewed.

The interviews with the Chief/Director Internal Audit generally took 1-3 hours and have been conducted between September 2010 and March 2011. In principle, the interviewees are the Chief/Director Internal Audit. However, to ensure that the participants have sufficient experience in their role and in the organization, in certain cases the deputy or the methodology manager of a specific internal audit function was selected. In most cases, additional questions were handled by email after the official, face to face interview. The results were recorded on basis of the semi-structured interview protocol (see appendix V) and returned to the interviewee for comments and additions to ensure the validity of the data. In addition, content analysis has been performed on provided internal firm plans and reports.
Although the focus is on the selected internal audit functions’ scope of work, the interview protocol includes a broader set of questions. The additional questions concern the structure of the function, the number of people, the internal auditors’ background, the reporting lines and the use of a control framework, which are considered relevant factors influencing the actual scope of work.

6.4 Results

6.4.1 Focus on maintenance versus adaptation and reprogramming
A first area of observations relates to the level of attention of the internal audit function for the maintenance of the status quo of their firm, and/or attention for the adaptation of the firm and, where applicable, for reprogramming activities of their firms. The table 6.3 illustrates the allocation of attention of internal audit functions to activities related to maintenance of the status quo and activities related to adaptation or reprogramming of their firm. The most important conclusion to be drawn from the table below is that the interviewed internal audit functions not only focus on the existing organization and processes (also called maintenance of status quo), but on the monitoring of the adaptation and in some cases the reprogramming of their firm as well.

<table>
<thead>
<tr>
<th>Levels of control</th>
<th>Scope of IA (n= 18)</th>
<th>Estimate of average attention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance of status quo</td>
<td>18</td>
<td>67%</td>
</tr>
<tr>
<td>Adapting</td>
<td>15</td>
<td>27%</td>
</tr>
<tr>
<td>Reprogramming</td>
<td>6</td>
<td>6%</td>
</tr>
</tbody>
</table>

Table 6.3: Allocation of time over level of control areas by interviewed firms

The interviews highlight that the main focus of the internal audit functions is related to assurance engagements covering the maintenance of status quo level of control. One of the reasons of this focus is the rotation plan of most internal audit

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68 During the interviews there have been discussions on the distinction between adapting and reprogramming. As the interviewees were not familiar with the terminology, there may be some bias in the division of attention between these levels of control.
functions to cover all entities within a certain number of years. This approach takes up most resources and time.

However, the interviews also highlighted more attention for pro-active monitoring activities in relation to changes and projects in the organizations. Internal audit seems to be aware that locking the stable door after the horse has bolted is useless. The interviews show that most of the time, internal audit is the initiator for more focus on monitoring projects, rather than the management board or Audit Committee (although it is supported as part of the approval of the internal audit plan). Internal audit adds value by providing early warning signals and comfort instead of hindsight advice and reports. This is made visible by the above table, that shows that 15 out of 18 firms devote time and resources to monitoring the implementation of changes within the organization, and 6 out of 18 are also involved in monitoring reprogramming activities. The attention for adapting and reprogramming seems to focus on project monitoring and assessment of appropriate project implementation; as a consequence, there does not seem to be attention for premise control. Premises are taken as a starting point, not as part of the assessment. Another way for internal audit to be involved in adapting and reprogramming activities is by facilitating risk assessments.

Some internal audit functions also seem to be more evolved in the awareness of its role and ability to create insight into root causes of control failures. This is in line with Ashby who during the 1950s already indicated that from a biological standpoint it is more important to address the reason for errors, instead of just highlighting and fixing them (Ashby, 1956; Otley, 1999). Emphasis on the root causes supports management with ways to make the appropriate changes within the organization, and to learn from the internal audit reports. In this sense, internal audit is an enabler to make the required change visible as well. This is also supported by research of the phenomenon of bounded awareness, meaning that humans regularly fail to see and use stimuli and information easily available to them (Chugh et al., 2007).
6.4.2 Breadth of focus on control elements
The interview framework also includes management control elements that had been discussed with the selected population. The results of their level of coverage of the different control elements are included in the table below.

<table>
<thead>
<tr>
<th>Control Element</th>
<th>Yes</th>
<th>No</th>
<th>Partly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy setting (including mission and vision)</td>
<td>0</td>
<td>18</td>
<td>0</td>
</tr>
<tr>
<td>Strategy Execution</td>
<td>9</td>
<td>9</td>
<td>0</td>
</tr>
<tr>
<td>Core values of a firm</td>
<td>13</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Structure</td>
<td>13</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Processes</td>
<td>18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Leadership and capabilities of people</td>
<td>3</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Compliance internal/ external laws and regulations</td>
<td>18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Budgets and performance monitoring</td>
<td>18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Reliability of financial reporting</td>
<td>18</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Information Technology</td>
<td>17</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

Table 6.4: Allocation of time over control elements by interviewed firms (n=18)

The above results indicate a link with earlier research by IIA (2010) and Paape (2007) and shows financial audit, operational audit, compliance audit and IT audit as main areas of attention. In the above table this is covered under processes, budgets and performance monitoring (69) (operational audit), financial reliability of information (financial audit), compliance internal/ external laws and regulations (compliance audits) and technology (IT audit).

69 This element is also partly covered under financial audit in case the focus is only on the reliability of the information in the monitoring reports.
**Strategy setting**

A notable result is the complete absence of involvement of internal audit in the strategy setting process (including possible changes to mission and vision which are input for the strategy development). The interviewees are unanimous in their opinion that the strategy setting process is a management task, possibly supported by strategy or business development functions and challenged by the Supervisory Board.

Internal audit does not seem to consider itself a challenger of the firm’s strategy, even though there is sufficient reason to take this into account (see also chapter 4). That is to say, from the field of administrative behaviour quite some audit attention areas and criteria, including underlying models and concepts from psychology, are available to be applied as audit tools. Various lines of research provide guidance for possible dysfunctional effects in the strategy setting process, such as the already mentioned bounded rationality (Simon, 1976), bounded awareness (Chugh et al., 2007), bounded knowledgeability (Giddens, 1984), dominant logic (Prahalad et al., 1986), belief conservatism (March, 1994) and groupthink (Janis, 1972), leading to incomplete or unrealistic strategies that may even miss waves of disruptive technologies or changes (Christensen, 1997). Internal audit may be the challenger of the logic and the consistency of the strategy and the underlying assumptions in areas such as market, competencies, financials, organization and execution of external developments. In this way, internal audit does not take over the role of the management or the Supervisory Board, but may strengthen the strategy process with its objective role and systematic and disciplined approach.

**Strategy execution**

50% of the interviewed internal audit functions (9 out of 18) allocate resources to the assessment of strategy execution. There is one internal audit function that recently transformed its purpose, role and scope of the function to include strategy execution in the scope of work and in the competency of the team. It explicitly assesses the strategy alignment between corporate and local strategy execution, and

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70 The strategy setting and execution was not separated in the integrative view as discussed under the theoretical framework (paragraph 6.2). However, during the interviews it became clear that these topics should be separated to provide a more balanced view with respect to the attention of internal audit in the strategy process.
assesses the assumptions and benefits of and realism behind the local strategy. The other internal audit functions that include strategy execution in their scope of work seem to focus more on monitoring strategic change programs or projects and less explicitly and in-depth on the assessment of the corporate strategy alignment with local strategies. In addition, it was mentioned that on occasion, internal audit teams up with its internal strategy function to perform a joint audit on strategic topics. This is also a good example of ensuring that appropriate knowledge and skills on strategy are covered during an internal audit on this subject.

This growing attention for strategy execution and its alignment may be a new trend in internal audit and is not misplaced. As mentioned before, misalignment can lead to a performance gap. A research from Mankins et al shows that many firms realize only 60% of their strategies’ potential value because of the misalignment of strategy, planning and execution (Mankins et al., 2005). Kaplan & Norton confirm this result with their studies (Kaplan et al., 2008). They provide an alternative method to Bower’s bottom up resource allocation process, which reduces the issue of agency costs, and includes the issue of intangible assets for which Bower failed to produce a solution. In addition, they discuss the bottom-up processes concerning emergent strategic opportunities. These opportunities sometimes emerge within the firm without any conscious process behind it (Bower et al., 2005; Mintzberg, 1978). The latter view shows the importance of interactive communication within the organization to capture this kind of emergent strategy (Simons, 1995).

However, the question whether emergent strategies are properly identified within a firm does not seem to be a part of any internal audit function. It could well be considered to be taken into account already, for example as part of the analysis of the allocation process and the bringing together of the rational and emergent strategies

Core values

The majority of the internal audit functions (13 out of 18) include core values in the scope of their work. In general, the core values are included in the so-called entity level control of the COSO framework. The COSO framework includes elements as a code of conduct, training regarding the code of conduct and the transparency of confirmations (sign-off) that all people understand the content of the code of conduct (COSO, 1992). These observations confirm the expected

71 Also see the books from Christensen and studies on innovation and new business models.
limited attention for values in a broad perspective, meaning broader than the code of conduct. Auditors in general mainly address the element integrity instead of values. This is mainly due to the COSO framework which limits itself to the element integrity and ethical values as part of the control/internal environment (COSO, 1994, 2004). COSO’s bottom line emphasis is to prevent fraudulent and questionable financial reporting practices. In this sense, integrity seems to be confused with honesty, which does not capture the full picture of integrity (Carter, 1996). The same applies to living according to a consistent set of principles (Carter, 1996), because these principles could not be in line with societal, universal principles.

Internal audit is expected to focus on values instead of on integrity only72. A role of internal audit functions could be to verify how these values are codified in the objective function, decision making, discussions, artefacts, rituals and perceptions, and monitoring. Furthermore, they are expected to assess whether the right type and hierarchy of values are in place (Strikwerda, 2011b). This is not common yet, as identified during the interviews.

Structure

Most internal audit functions (13 out of 18) include the structure of the internal organization of a firm in the scope of internal audit. All respondents are clear on the scope of this area; they do not assess the structure on a global level, since that is the responsibility of the Management Board.

Internal audit assesses the structure of the organization on lower levels (such as business unit levels) of the organization. In the interviews, it links to the internal environment of COSO which includes the element ‘organizational structure’. The element ‘structure’ is mostly interpreted as the proper functioning of documented decision rights, authorization limits, reporting lines and, in a few cases, is linked to incentive management. Others make the link to audits of the governance structure of joint ventures and alliances. Changes in structure are taken into account during internal audits as well, for example to verify the effectiveness of a new way of working and handover between functions.

72 Discussion with management on the implementation and embedment of values is probably more a matchup with the vocabulary of management than with soft controls. The term soft controls has been well-known in auditing since the 1990’s, but has not been adopted by management as yet. However, both deal with the question of influencing the behaviour of managers and employees as part of managing and controlling a firm.
Internal audit assesses the existence and operation of the defined structure, authorization limits etc. The respondents (with exception of those who also look at strategic alignment) do not seem to assess the logic and assumptions behind the various forms of a firm’s internal organization (e.g. link between strategic themes, fit to the market and the operational processes) while there has been extensive literature on criteria to audit the design of the objective function, the organization of information and its related organizational structure (Chandler, 1990; Strikwerda, 2000, 2005b, 2008).

**Process**

All 18 respondents include operational and supporting processes in their scope of work. It even seems to be the core area of attention of many internal audit functions. Processes are covered by so-called operational audits. All internal audit functions use a risk-based approach that covers entities, processes, joint ventures (and themes such as license agreements and export activities).

Some respondents mention that their scope still mainly relates to financial-based control with a mixture of business control, but not always covering all control elements related to the core, primary processes. This raises the question whether procedural knowledge (testing the procedures without necessarily being an expert on the content of control) is sufficient or that more substantial knowledge (tacit content knowledge and experience) is required to assess the effectiveness and efficiency of operations as well. The latter requires a multidisciplinary team of internal auditors, which is not yet in place at all internal audit functions (also see later paragraphs of this chapter).

**Leadership and capabilities**

All respondents acknowledge the importance of the subject for the control of the firm, but also explain that it is not (7) or only partly (8) a subject for the activities of internal audit. There were 3 respondents who include these subjects in the scope of their audits as part of the HR related control. For example, they assess the effectiveness of the leadership program within entities of the firm. Leadership is mainly seen as less tangible, and is observed in an indirect way by linking it to incidents in relation to the code of conduct, values and other policies and procedures. As such, this subject is more exception-based and incident-driven. It is also part of informal discussions with top management, outside the formal reporting process. The capabilities of people seem to be more measurable and as
such are taken into account as part of the HR control system, e.g. job requirements, existence of functions, talent management and succession planning.

As reflected in the research by Paape (2007), the subject tone at the top does not seem to be in scope yet. This is also the overtone during this research; the Management Board does not seem to be part of the scope of internal audit functions. The Board is (within a two tier Board) the principal of the internal audit function and they see the domain of internal audit ending below the Board, not including the Board. Nevertheless, the question remains why internal audit should not be involved in this area, as leadership by top management is an essential element of a firms’ control system. As mentioned earlier with the strategy setting process, history and research show that leadership may have a dysfunctional effect on the control of a firm. This has been highlighted yet again by a recent study on CEO narcissism overload (Rijsenbilt, 2011). Rijsenbilt indicates that moderate levels of CEO narcissism can be productive and can add value to the firm, but organizations need to be aware of the potential destructive behaviour of high levels of narcissism without sufficient countervailing power. In addition, the Management Board may be assessed on their required roles as described in chapter 4 under leadership, such as the requirements of Fayol and the roles with respect to entrepreneurship, communicator within and outside the firm, decision maker and transformer.

Compliance

All respondents (18) include compliance in their scope of work as part of their standard work program for every entity audit or as a theme in a specific year as a returning topic, based on a risk assessment. Some respondents provide a subtle distinction by separating internal and external compliance. They mention that internal audit’s scope is related to compliance with internal procedures. Other functions, such as legal or compliance are responsible for capturing the external laws and regulations in internal policies and procedures and for implementing these within the organization. Internal audit is the assessor of the operating effectiveness of these policies and procedures. During the interviews some discussion developed on the scope of compliance; for example the Sarbanes Oxley requirement for U.S. listed firms was sometimes considered an element of compliance. In this study, this element will be captured under reliability of financial reporting. Other examples of highlighted compliance elements are privacy, health and safety (including, for example, food and product safety), anti-competition, anti-bribery (such as U.S. FCPA and U.K. Bribery Act), export control and anti-money laundering (AML).
The inverse of compliance is also a relevant element of most interviewed internal audit functions. Investigations of non-compliant behaviour or fraud investigations are part of the scope of work at 16 of the 18 interviewed respondents. The other 2 firms have a separate security & investigations function which performs these kinds of investigations. The trigger for non-compliance investigations are requests from the Audit Committee or management based on accounting and/or compliance issues (e.g. whistleblower issues).

*Budgets*\(^{73}\) and *performance monitoring*

Budgets and performance monitoring is in scope of all the interviewed internal audit functions, especially in the area of auditing the existence and reliability of performance parameter reporting. The assessment of the *relevance* of parameters in relation to the strategy and objectives of a firm is a less convincing topic of internal audits, although some explicitly mention it is also part of their scope of work. However, the determination of critical parameters, besides its reliability, is equally important from a management control perspective.

The budget process is usually discussed at length by corporate and local management and controllers. The budget game is a well-known subject by now. March and Simon indicate that objective setting is a political process, in which differences in goals and in perceptions of reality may be a condition for intergroup conflict (Cyert et al., 1992). On the other hand, Locke has empirical evidence that suggests that goal setting increases performance and motivation (Locke, 2001). The extensive attention for the budget process is related to proper attention for politics, power and psychological factors and at the end a proper resource allocation process (Hofstede, 1981). For this reason, the fact that internal audit is not heavily involved in this process is not awkward, although some take a role in the assessment of the design of the process and the alignment of strategy and budget.

The performance reporting is more of a topic for internal audit. The background of this request may be aligned with the agency theory and the related information asymmetry. The interviews show that Management Boards wish no surprises and therefore require internal audit to perform independent checks on the information supplied by local management, to ensure that this information is reliable. This

\(^{73}\) The element ‘budgets’ is also part of strategy execution, as it relates to the resource allocation process. In this chapter it is combined with performance monitoring to remain consistent with the approach of chapter 4.
agency issue may be solved in the near future, as many firms make the transition to central access to information of all entities.

Remuneration is also part of the performance process and, although not always explicitly discussed during the interviews, an explicit part of certain internal audit functions, for instance as part of the HR risks or on the Audit Committee’s request. Incentives and rewards are key elements of the agency theory, as it presumes alignment between the interests of both principal and agent. History shows that remuneration systems have led to cooking the books activities and manipulation of short-term earnings, therefore, this element should be a standard topic of all internal audit functions (Paape, 2007).

**Reliability of financial reporting**

All 18 respondents include reliability of financial reporting in their scope of work. The attention for this topic varies between 2% and 75% of available time for an internal audit. The discussion reveals the following differences in approach. The internal audit functions with a low percentage of work in this area limits these activities to resources dedicated to external audit/statutory requirements with respect to the annual report and sustainability reporting. The work is mostly related to smaller entities within a firm that are not in scope for the external auditor, but about which the Management Board and Audit Committee want to be reassured that they are in control. Other internal functions, with a higher percentage of allocated resources to this area, include assurance activities centring on compliance with accounting principles and the control framework for this area (such as Sox testing).

**Information Technology**

Most internal audit functions (17 out of 18) include information technology (interpreted as IT systems, but also extending to areas such as social media) in the scope of their function. One internal audit function does not include IT in its scope as this is performed by another function. The kinds of audit vary from traditional IT audits for financial statement reliability, to integrated operational audits covering process, financial, compliance and IT knowledge, to pro-active project

74 IT auditors have in line with COSO their own control model called COBIT (Control Objectives for Information and Related Technologies framework). This framework has the similar gaps as COSO and will therefore not be explained further in this thesis.
audits of large IT implementations or migrations. Due to advances in technology more manual control activities are automated, which requires more internal audit attention in this area. There are also developments in continuous auditing based on technologic developments. These enable internal audit to limit assessment efforts and to focus on other areas.

6.4.3 Analysis of differences between firms

A next step in the analysis of the results of the empirical research at 18 Dutch AEX firms is to explore variables that may influence the scope of internal audit functions. The following variables will be explored:

- Purpose of internal audit function
- Size of internal audit function and related industry
- Existence of other assurance functions
- Background of Internal audit team
- Reporting line

Purpose of internal audit function

The majority of the interviewed internal audit functions (13 out of 18) adopt the IIA definition. The IIA defines the field of internal audit as follows:

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

However, five internal audit functions deviate from the others and have their own definitions. In general, common elements such as assurance, independence and quality of control also apply to the deviating definitions and overall there are two interesting points in these deviating approaches:

Two internal audit functions explicitly mention that they provide re-assurance, thus meta-control, as management has the primary responsibility for providing assurance on the level of management control. This emphasis highlights the responsibility of management and positions internal audit more clearly as an assessment function. The IIA definition is more fuzzy, capturing everything, and creates confusion by including the consulting activity besides assurance. During the interviews it has become clear that all internal functions mainly focus on
providing *assurance*. Some even explicitly mention that consulting is a different profession and is not an element of internal audit; this should be done by other specific functions within a firm or specific consulting firms.

There is also one internal audit function with explicit attention for process harmonization, identification of process improvement opportunities and gathering and sharing of best practices. The basis of this activity relates to the end-to-end review on key business processes and providing reassurance that all risks pertaining to the processes are well understood and managed. This makes the natural advisory role very explicit and aligned with the continuous improvement of processes, rather than on only providing assurance.

The interviews also included a question regarding the trigger to set up an internal audit function. Half of the interviewed firms have had an internal audit function for over 20 years, others since the new century. In general, the reason why is linked to the growth of a firm and the continuing need for timely, reliable and accurate (financial) information from its decentralized units. As the control function could no longer be covered by management, additional control was needed by other monitoring functions, such as internal audit. Furthermore, it was a way to lower external audit costs and to improve the quality of process and learning. Other reasons are the requirements of the Sarbanes-Oxley law or the initial public offering (IPO) on a stock exchange. A close link to financial audit as a basis is present at all firms, and is maintained over the years.

The expectations of the Management Board and Audit Committee regarding the purpose of internal audit came across during interviews as well. In general, the feedback was quite consistent; internal audit is the eyes and ears within the firm and the Management Board and the Audit Committee see a monitoring role for internal audit to prevent any surprises, especially in the area of financial reporting and fraud. Some also mentioned that the Board sees internal audit as a function to signal to and share best practices with various parts of the organization.

**Size and industry**

The interviewed population differed in number of employees within their internal audit functions.
Table 6.5 shows the differences in size:

<table>
<thead>
<tr>
<th>Number of IA employees</th>
<th>Number of firms</th>
<th>Rounded percentage (n = 18)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;10</td>
<td>7</td>
<td>40%</td>
</tr>
<tr>
<td>10 to 50</td>
<td>5</td>
<td>30%</td>
</tr>
<tr>
<td>50 to 100</td>
<td>3</td>
<td>15%</td>
</tr>
<tr>
<td>&gt;100</td>
<td>3</td>
<td>15%</td>
</tr>
</tbody>
</table>

Table 6.5: Number of IA employees divided over interview firms (n=18)

Although the researched population is small, the results appear to be in line with earlier research by Paape (2007: p. 55); at 40% of the firms the internal audit functions includes less than 10 employees, 30% have 11 to 50 employees and around 30% of the interviewed firms have more than 50 internal audit employees.

A further analysis of the number of internal audit employees in relation to the total number of employees within a firm has been completed and places the number of internal audit employees in the context of the whole organization. The comparison is shown in table 6.6.

As expected from earlier research, the financial industry has the highest levels of internal audit employees in relation to the total number of employees with a percentage between 0.38% and 0.75%. The percentage of internal audit employees in relation to total number of employees of most firms is mainly between 0.02% and 0.09%. This small dataset does not show a consistent link between the size of the firm and the size of the internal audit functions.

Furthermore, a link is made with the scope of services of the interviewed internal audit functions and the size of their function. Mainly the larger internal audit functions (> 20 employees) cover elements such as strategy execution and leadership besides the other control elements.

75 There are slight differences in the percentages for organizations that have between 10–50 internal audit employees (5%–10% more in Paape’s study) and organizations that have more than 50 internal audit employees (5%-10% less in Paape’s study).
The internal audit functions with less than 5 employees focus only on control for financial reporting. However, more research is needed to provide significantly relevant results.

<table>
<thead>
<tr>
<th>Percentage of total number of employees</th>
<th>Number of IA functions</th>
<th>Kind of Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.01%</td>
<td>1</td>
<td>Oil &amp; Gas instruments</td>
</tr>
<tr>
<td>0.02%</td>
<td>3</td>
<td>Consumer business, Building, Professional Services</td>
</tr>
<tr>
<td>0.04%</td>
<td>3</td>
<td>Consumer business, Transport, Media</td>
</tr>
<tr>
<td>0.07%</td>
<td>2</td>
<td>Consumer electronics, Telecom</td>
</tr>
<tr>
<td>0.09%</td>
<td>5</td>
<td>Consumer business, Chemicals, Technology, Construction</td>
</tr>
<tr>
<td>0.17%</td>
<td>1</td>
<td>Technology</td>
</tr>
<tr>
<td>0.22%</td>
<td>1</td>
<td>Oil &amp; Gas</td>
</tr>
<tr>
<td>0.38%</td>
<td>1</td>
<td>Financial Services</td>
</tr>
<tr>
<td>0.75%</td>
<td>1</td>
<td>Financial Services</td>
</tr>
</tbody>
</table>

Table 6.6: Percentages of internal audit employees in relation to total number of employees of researched firms and per industry (n=18)

**Existence of other assurance functions within a firm**

The scope of an internal audit function may depend on other functions within the firm that also provide support and assurance on specific areas. The interviews indicate that within all firms other functions exist that provide support or assurance in areas such as risk & control, quality, health & safety and environment, project value assurance (VAR), compliance, store audit, information security, asset protection and food-safety. In some cases, different committees combine different functions as well, such as the Business unit Audit Committee, Ethical committee, Compliance committee, Risk committee.
The most direct link is between internal audit and the risk & control functions. In 13 out of 18 interviewed firms, such a function exists for risk assessments and developing, adjusting and testing the control framework. These activities seem to overlap with the work of internal audit. In most cases, internal audit relies partly on the work of the risk & control functions and partly on additional checks to verify the completeness and accuracy of their work. This system of control enables an external auditor to rely on this system and limits the work in verifying the control framework. The existence of a separate risk & control function may indicate that internal audit can refocus its resources on other elements (broader view on internal audit) or it can be a trigger to limit the resources of an internal audit function (narrow view on internal audit).

An interesting theme is how the other functions relate to the work and scope of internal audit. As early as in the 1990’s, discussions on integrating more distinct audits, such as ISO, legal, environmental and health and safety audits within the internal audit function took place (Paape, 1995). It showed a further shift from financial audit towards the examination and evaluation of the quality of control designed to assure the accomplishment of entity goals and objectives (Paape, 1995). In 1999, a Dutch IIA report considered different kinds of audit, such as health and safety, environmental, legal and ISO, as something outside the internal audit function. In 1999, there was neither need to link these functions to internal audit, nor to integrate them.

Currently, within some firms other assurance functions are integrated within the internal audit function (such as quality/ISO audits or HSE) or are reporting to internal audit (HSE). This is also in line with the IIA position paper which includes different kinds of audit under the umbrella of internal audit (IIA et al., 2005). In general, the internal audit function liaises regularly, co-ordinates with and takes account of the work of other assurance functions across the group. This can be done informally, and/or via committees and/or by agreeing each other’s framework to avoid assurance gaps and to minimize areas of overlap. The interviews did not indicate that the latter is common at every firm. This may be an attention area for some internal audit functions. Firms may rethink the reporting structure of the assurance functions as many of the heads of internal audit have grown into a Chief Audit Executive (CAE) role. This role presumes that they act on C-level with related oversight. From that point of view it may seem logical to let the CAE coordinate the assurance functions. This will result in a better coverage of different potential risk areas and the ability to provide an overall assurance statement towards the Management Board and Audit Committee. It is, for example,
interesting to note that a new element such as sustainability audits is almost automatically parked under the responsibility of internal audit, while other elements such as health and safety & food safety audits are not transferred to the responsibility of internal audit.

This overall coordination should, in the end, lead to expertise to provide assurance to the overall in-control statement of a firm. In general, the internal audit function is one of the players in the control statement process or provides assurance on the management in control process. The interviews resulted in the observation that the question on sufficient coverage to provide assurance or comfort leads to the in-control statement, which is mainly related to a system leading to a reliable annual statement and sustainability statement. This seems to return the focus and scope of the in-control statement to financial reporting & financial control. Is this the essence of the scope of internal audit?

The interviews show that their expertise is broader, covering the areas of strategic, operational, financial and compliance control or subject matter expert areas in relation to potential risk areas. Others mention they are only expert in the area of administrative organization, excluding the control areas concerning the core, technical processes (this is seen as a task for consultancy firms). This seems to be in line with the in-control statement focus. In general, they agree they oversee all entities and processes, however limited by their risk-based approach. Another angle is that they have the authority to involve themselves in various control issues and subjects. Internal Audit is the function that can be critical and can start a discussion and promote continuous improvement.

**Background team**

The background of the chief auditor and his team may be an influencing variable for the scope of the internal audit functions. A first influence may be indicated by the background of the chief auditor. More than 50% of the chief auditors at the interviewed firms have an educational background in audit (RA, CPA, etc.) and most of these auditors used to work at an audit firm. However, there is also a tendency of new chief auditors who do not match these criteria and have more of a business background (including finance functions). Larger firms in particular seem to hire this kind of chief auditor.

There is also a link between the background of the chief auditor and his team. At certain firms, where the chief auditor has a business related background, the team is hired from the business and/or are only temporarily part of the internal audit
function and will return to the business after a certain period. The team also reflects the different core functions of the firm; the team members with a financial background cover no more than 50% of the resources. This approach of a mix of career auditors and non-career auditors is common sense at the large non-financial, multinational firms that are interviewed. At other firms as well, the diversity between career auditors and non-career auditors and guest auditors from the business and/or a need for specialist knowledge are a growing trend. This is also in line with the position paper of the IIA of 2005, which emphasizes the well-known statement about 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 areas. However, it is not yet common among the majority of the interviewed internal audit functions. The majority of the internal audit functions only cover the traditional R-factor (such as RA, RO, RE).

**Reporting line**

The relevance of the reporting line for the scope of internal audit is twofold. Firstly, it relates to reporting as part of the corporate governance requirements. Secondly, it relates to the internal governance of the internal audit function as part of a global organization.

Internal audit needs to operate under the responsibility of the Management Board and have access to the chairman of the Audit Committee according to the DCGC (Corporate Governance Code Monitoring Committee, 2008)\(^76\). In practice, all internal audit functions report to the CEO of the Board (10 internal audit functions) or the CFO of the Board (8 internal audit functions) and to the Audit Committee (17 of the internal audit functions\(^77\)). Two firms have a one-tier Board and report primarily to the Audit Committee. Administratively, they report to the CFO which is not in line with the position paper of the IIA (2005).

\(^76\) This approach is described for two-tier Boards and not for one-tier Boards such as Shell and Unilever.

\(^77\) One internal audit function did not yet report to the Audit Committee although the company had an Audit Committee set up.
In the 2005 position paper of the Dutch IIA, the internal audit function still was positioned mainly under the Management Board as described below (IIA, 2005: p. 5, 10):

*The duty of the internal audit function consists of providing additional assurance to the managing director and the management of an organization on the effectiveness and the control of the business operations.*

*Communication with the Audit Committee will primarily go via the executive Board.*

Corporate governance and oversight by Audit Committees has made a next step. Especially in the Anglo-Saxon literature, some authors propose internal audit as one of the cornerstones of corporate governance (Holt et al., 2009; Stewart et al., 2010; Strand Norman et al., 2010). The other cornerstones are management, the Audit Committee and the external auditor. In this view, internal audit is much more an independent function of management rather than the tool of management approach as supported in the Netherlands. The question to be asked is whether this Anglo-Saxon approach will emerge in the future for listed firms with a strengthened monitoring role in relation to the Audit Committee. As a consequence, the scope of internal audit may then also include the Management Board and the strategy process, instead of only focusing on the business units as in the past.

The internal governance of internal audit has also changed over the past few decades due to further professionalization, scandals and external developments (such as the Sarbanes-Oxley law). Some functions mentioned the change from a regional to a global audit function, centrally led from the corporate office. The trigger to centralize internal audit coordination was to ensure overall insight and quality, so no risks would be missed or remain out of the Management Board’s and the Audit Committee’s sight. This centralization can further strengthen its role as cornerstone of corporate governance and its scope, broader than mainly financial and operational audit.

### 6.5 Summary and concluding remarks

This chapter explored the actual scope of Dutch AEX listed firms’ internal audit functions and explained possible differences between the internal audit functions’ scope and the theoretical model for control. The following concluding remarks can be made based on the exploration:
First of all it can be concluded that the interviewed internal audit functions not only focus on the existing organization and processes (also called maintenance of status quo), but are involved in the monitoring of the adaption and in some cases the reprogramming of their firm as well. Internal audit functions seem to be aware that locking the stable door after the horse has bolted is useless. However, the main focus is on assurance engagements covering the maintenance of a status quo level of control.

Secondly, the familiar control elements such as budgets and performance management, process control, reliability of financial reporting, compliance and information technology are part of the scope of the interviewed internal audit functions. Broader management control elements such as strategy setting, execution, core values, structure, leadership and capabilities are less standard elements of the scope of all internal audit functions due to the lack of knowledge, experience and confidence. However, the control problem of the firm, as the various scandals and crises suggest, rests within these elements as well. Furthermore, the interviews indicated limited connection with institutional developments, meaning the emergence of intangible assets and decreasing importance of tangible assets, requiring a different approach to control and to audit.

Thirdly, the majority of the internal audit functions use the IIA definition and deviating definitions include common elements such as assurance, independence and quality of control as well. The main difference is the focus on either consulting or assurance; the latter is already the main focus of the internal audit functions. The term consulting remains fuzzy. Most interviewed (not all) internal audit functions seem to be followers regarding what to audit or not, for example, based on their rotation scheme and on the approach and/or scope of external auditors. As a consequence, the broader comprehensive view of control is applied limitedly. A more focused definition or an operationalization of the IIA definition may provide more clarity for the internal audit function itself and its environment.

Fourthly, differences between the scope of work of internal audit functions may be explained in part by the background of the internal audit team. Currently more than 50% of the chief internal auditors have the R-factor. However, there is a tendency to hire new chief internal auditors with a business background (including finance). The same applies for the internal audit team and the multidisciplinary nature of the team to cover all main core processes and functions of a firm. This also affects the scope of work that is seen at some of the larger internal audit functions. Elements
such as strategy, strategy alignment, core knowledge of processes and regulatory compliance topics should be integrated in the multi-disciplinary team.

Fifthly, there is a growing importance for the role of the Audit Committees. The question to be asked is whether the Anglo-Saxon approach for listed firms with a strengthened monitoring role for the Audit Committee is the future in the Netherlands as well. As a consequence, the Management Board and the strategy process may become part of the internal audit’s scope, which will no longer merely focus on the business units as was the case in the past.

Sixthly, the use and integration of assurance functions are widely dispersed areas within the interviewed firms. Firms may rethink the organization and the reporting structure of the assurance functions, since many of the heads of internal audit have grown into a Chief Audit Executive (CAE) role with related oversight. From that point of view it may be logical to let the CAE coordinate the assurance functions. This will result in a better coverage of different areas of the comprehensive control system and the ability to provide an overall internal assurance statement to the Management Board and the Audit Committee.

There are certain limits to this study and possibilities for future research. The empirical findings should be interpreted in the right context, given the exploratory nature and relatively limited number of firms (18) taken into account. Future research on a larger scale is necessary to strengthen the results of this study.

In addition, the current study has been performed on the basis of interviews and limited documentary research. There may be a risk of misinterpretation of information given the nature of the research. More in-depth research, perhaps supported by questionnaires, may help to build on the results of this study.

Future research on this topic, including the Management Board and Audit Committee members, may lead to new insights and rationale for choices made. This could further enhance embedding internal audit functions and their contribution to the control of the firm. At present, Management Board and Audit Committee members may have an outdated but dominant view on the role of internal audit, that does not match its current purpose and scope.