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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Citation for published version (APA):

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7. Summary and Conclusions

7.1 Introduction
This research started with the observation that increased (regulatory) demands for accountability have made a firm’s control systems part of the public policy debate on audit and corporate governance (Maijoor, 2000). This attention related mainly to internal accounting control (or AO/IC as it is called in Dutch), to ensure a reliable financial statement. The attention to the meaning of control in the Netherlands increased as a result of the scandals and financial crises. Proper internal accounting control was an element to improve the control system of a firm, however, the control problem of the firm, as the events suggest, reside at a higher level.

Economic changes occurred while different international corporate governance committees drafted their codes. More recent economic literature shows awareness of the shift from physical assets to human, information and organizational assets. It shows insights that the nature of firms is changing. This change was not sensed and adopted by mainstream management control academics, nor in the practitioners’ theories of governance, accounting or auditing. Corporate finance literature describes this translation as a change of focus from accounting profit to economic profit, requiring a different approach to control and to provide assurance. More recently, Kaplan and Norton operationalized this change in the nature of the firm in their books as well.

Another observation was that there is no common, comprehensive theory regarding the concept of control; different concepts for control are assumed in various researches, depending on the academic field involved. Subsequently, no adequate theory exists on internal audit’s role in and contribution to the external or internal control system of a firm. This hampers adequate development of this profession in relation to developments in the economy in general and micro-economics in particular.

Up to now, the internal audit profession’s involvement in the corporate governance discussions in the Netherlands has only been indirect. No internal audit representative was involved in the commission and there was no clear understanding concerning the role of internal audit. In the Netherlands, only two studies are known in this field: a dissertation by Paape (2007) on the impact of corporate governance on the role, position and scope of services of internal audit
and a dissertation by De Bruijn (2010) on the role of internal audit in relation to the laws and regulations of professional bodies. This study expands on those researches.

The purpose of this research was to *explore* literature and current practice to obtain a clear view of internal audit’s theoretical and practical contributions to the reasons of *existence* and *scope of work* in the control system of a firm. The central research question of this study is: *What is internal audit’s reason of existence and scope of work in the control system of a firm?*

### 7.2 Summary of findings and their implications

This study investigates five different areas of attention to answer the different areas of the central research question.

*The first area of attention* relates to the literature on the origins, purpose and scope of internal audit. In general, internal audit has developed from traditional accountancy and financial control into operational control testing and training, consulting activities such as risk management facilitation and corporate governance support to the Audit Committee and external auditors as part of their duty to monitor the internal risk and control system. During the implementation of Sarbanes Oxley regulation (SOx) there was some fear of damaging its professional status, but this now seems to have been resolved. Although IT is mentioned as a fundamental part of modern firms and, therefore, expected to get attention in academic articles, this has not been the case in the selected internal audit related journals.

The main premises for the present internal audit functions were defined in 1999, covering elements such as *scope* (assurance and consulting activities to add value and remain viable; a broader scope than that of financial audit by covering governance, risk management and control), *organization* (internal and/or (partly) outsourced), *governance* (relation with management, the Audit Committee and the external auditor) and being a standard based *profession*. There have been a limited number of changes in the field of internal audit since the new IIA definition in 1999. Several corporate failures provided a boost for internal audit during the SOx period from 2004-2006, but silence reigned during the financial crisis of 2008-2010.

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. Furthermore, the perspective chosen seems to have a closed systems perspective that does not cover changes in the institutional context of firms and its environment. From an academic perspective, there are limited fundamental, integrative articles on internal audit, and no articles that suggest new theoretical insights, approaches and/or methods on additional value provided by an internal audit function. This study has closed this gap by exploring its origins, development and raison d’être and by structuring the different articles, theories used and latest theoretical insights.

The second area of attention, the exploration of a theoretical foundation, looks at the firm as a meta-theory on analyzing its control system from an economic point of view, as well as the role of internal audit. The theory of the firm is far from homogenous and involves different views. These different views (agency, transaction costs (TCE), property rights and the resource and knowledge-based view (RBV, KBV)) provide different dimensions/issues that can be complementary to each other and to the internal auditor, by analyzing control issues within a firm. The different theories highlight the fundamental questions of the Coasian theory of the firm related to why a firm exists (TCE, property right view, RBV, KBV), what the boundaries (TCE, property right view) of a firm are and the internal organization of a firm (Agency theory, property right view, RBV, KBV). In addition, the discussed theories of the firm provide insight into the assumptions behind the existence, boundaries and mechanism of internal organization.

Fundamental assumptions are bounded rationality (agency theory, TCE), information asymmetry (agency theory) or information impactedness (TCE), the importance of boundaries of a firm by ownership or access to assets (property rights view, RBV, KBV) or asset specificity (TCE) and maximizing behaviour and related incentive issues (agency theory, property rights view).

The different theoretical views of the firm imply that internal audit functions as a double loop control mechanism at corporate level of a firm (agency, TCE). Internal audit’s reason of existence is to support the firm and its management to highlight possible cases of information asymmetry and incentive issues between the Supervisory Board and Management Board and local management. Furthermore, the economic perspective also emphasizes the contribution to the performance and value(creation) of the firm (RBV, KBV). The advantage of internal audit over external monitors is their greater freedom of action, its wider scope, its understanding of the language of the firm and the possibility to rely on less formal evidence.
The third area of attention covers the exploration of a theoretical foundation from a control perspective. Various views on control are investigated to explore broader theories and elements of a control system of a firm. On the whole, biological cybernetics, information theory and management (control) theories are a useful and more practical addition to the economic point of view. A comprehensive theory of control is formulated by using the biological cybernetics and information theory supported by insights from organization theories. Its concept of analysis is a living system which is explicitly organized for information processing to effect control and to remain alive in an open system. This is in line with firms who are information driven constructions, competing with their rivals and aligning with their environment to adapt and remain alive. However, it should also be noted that the comprehensive theory as described in this chapter has not been adopted yet in current management, management control, management accounting studies. Based on the literature study some assumptions are made clear, to help focus on essential elements of a control system of a firm. These assumptions are not static and can change as a result of changes in the institutional environment. The logic of falsification cannot always be applied and principles, therefore, may be seen as temporary “crutches” to assist making sense of what we find as we go along, and to be used only until a better means can be found. Internal audit is also expected to adapt and reprogram its scope of work and audit programs to remain viable within a firm. The current internal audit standards are too generic and high level to provide sufficient guidance on the question whether a firm is really in control in the previously described areas. Internal audit as a profession should be keen on sensing fundamental changes, and should prevent adopting management hypes or fads. Therefore, the cybernetic theory of control, together with the insights from administrative behavior, organization theory and the theory of the firm (such as the resource and knowledge-based view and the dynamic capabilities view) provide a more comprehensive view on control for internal audit functions and the determination of their scope and required knowledge and skills.

The fourth area of attention is the exploration of possible critical explanatory variables for the existence of internal audit in the Netherlands, taking into account previous international research on this topic and contributing to the growing body of literature. This study indicates that the following significant variables could be linked to the existence of internal audit: Turnover, Total Assets, FTE, Number of Countries. These variables are indications of the Size and Complexity of a firm. This is consistent with the earlier research of Wallace & Kreutzfeldt (1991), Carcello et al (2005) and Goodwin-Stewart and Kent (2006). However, contrary to Goodwin-Stewart and Kent (2006), this research found a significant relation
between complexity and the existence of internal audit. The reason may be the selection of another measure (number of countries instead of business segments). The significant variables show that the turning point for the existence of an internal audit function is around EUR 1,600 million Turnover, EUR 2,100 million Total Assets, 6,500 FTE, or doing business in more than 15/16 Countries. However, these variables are not significant in the equation. The most significant relation in the equation is that of the variables Total Assets and Number of Countries. Some NYSE Euronext listed firms do not align with the above criteria and unexpectedly do or do not have an internal audit function. Future research may be performed to unravel the rationale behind these choices.

The fifth area of attention concerns the confrontation of the actual scope of work of internal audit functions of AEX listed firms in the Netherlands with a broader, multidisciplinary view on a control system of a firm. The confrontation shows that the interviewed internal audit functions not only focus on the existing organization and processes (also called ‘maintenance of status quo’) but that they are also involved in the monitoring of the adaptation and in some cases the reprogramming of their firm. Internal audit functions seem to be aware that locking the stable door after the horse has bolted is useless. However, the main focus is related to assurance engagement covering the maintenance of status quo level of control. 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. 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 lack of knowledge, experience and confidence. However, the control problem of the firm, as the events of the various scandals and crises suggest, rest 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. This study shows that the broadness of the scope of the internal audit functions is closely related to the size and team composition of internal audit functions and less directly influenced by their purpose and reporting line.
7.3 Implications of the findings of this study

The following implications can be noted after combining all areas of attention. The current state of internal audit as marked in the position paper of the IIA (2005, 2008) may need some revision to look ahead to 2020.

Reason of existence of internal audit

1. The requirement to set up an internal function as an additional, independent monitoring function depends on the size and complexity of a firm. This study explored a formula to determine whether or not a firm requires an internal audit function, based on a limited number of critical variables. This may prompt some firms to set up an internal audit function within Dutch listed firms.

2. The requirements defined in the regulatory context of the firm, such as in the Dutch Corporate Governance Committee (DCGC), to deploy an internal function are based on a narrow view of control (the reliability of the annual report) and, therefore, of internal audit. A more comprehensive view on control should be adopted by the DCGC, aligned with the current institutional context and economic changes.

3. Internal audit is a function within the internal organization of a firm. Internal audit is not a management tool but a monitoring function as part of the governance of a firm as a whole. Subsequently, a Management Board of a 2-tier structure is not solely responsible for internal audit, but shares this responsibility with the Audit Committee, i.e. the appointment of chief internal audit, the approval of plans and the discussion of the overall findings, conclusions and actions from internal audits. As a consequence, the scope of internal audit may then also include the Management Board and the strategy process.

Scope of work of internal audit

4. In order to be of value for firms, the economy and society, internal audit should focus on the meta-control of the firm and develop the skills and core competence needed for this role. Its primary role is to provide insight into and assurance of the different elements of the comprehensive control system and to have its related natural advisory role. Internal audit does not
provide consulting services\textsuperscript{78}. It is suggested to adjust this in the IIA definition of internal audit.

5. The scope of internal audit covers, firstly, all the different levels of control (maintenance, adapting and reprogramming) and secondly, the areas of strategic, management and operational control\textsuperscript{79}. Control over financial reporting is one of the basic building blocks for a firm to be in control, but this should not be the sole area of focus of an internal audit function.

**Conditions behind existence and scope of work of internal audit**

6. Professional internal audit associations provide standards for performing structured and disciplined internal audits. However, a broader set of literature provides the norms to use for assessing strategy, operations, reporting and compliance objectives. COSO is not a comprehensive control model and does not include sufficient management control language. This thesis described the broader set of literature and norms to be used.

7. Internal audit will, dependent on the purpose of their function\textsuperscript{80}, have a sufficient level of multidiscipline in its team to cover the core competences of their firm in relation to risk areas. This is broader than just covering the different R-competencies.

8. In case there is sufficient reason to set up an internal audit function (which is broader than control over financial reporting) then this function should also have a sufficient level of resources available to cover all relevant areas and to be able to attain the objectives of their Audit Charter.

9. As described by Polanyi (1962: p. 112) different vocabularies for the interpretation of things divide group which cannot understand each other’s way of seeing things and acting upon them. At present, much internal audit literature is still full of audit jargon and technical language. As a

\textsuperscript{78} There may be an exception for non-mature organizations where control processes need to be developed in case of a lack of control processes. In that case the internal audit function is not an assurance provider, but is more an internal consultant. This should be included explicitly as its role in the Audit Charter. However, this can never be a long-term internal audit role, because that is the role of assurance provider.

\textsuperscript{79} All elements also cover financial and IT elements.

\textsuperscript{80} Multidiscipline outside the R-competencies does not apply in case the purpose of the internal audit function is to limit its scope to internal control for financial reporting. This would be a narrow fulfillment of its role and may be captured under the corporate controller department of a firm.
consequence, people outside the audit world do not always understand the vocabulary and for example management may not get the full meaning.

10. Internal audit will not judge the set-up of specialized assurance functions as mentioned in the Dutch IIA position paper of 2005, but will need to integrate them within its function, such as HSE, Quality, and other compliance related functions\textsuperscript{81}. This integrated approach will ensure sufficient coverage, prevent overlap and save compliance costs.

11. The external accountant is one of the external parties with whom internal audit aligns its work, as this is only a part of its work. This should also apply to other external parties such as DNB (De Nederlandse Bank) and AFM (Autoriteit Financiële Markten), etc. The thought behind this statement is mainly to limit the explicit and implicit dominance of external audit, also from an institutional context point of view, to be able to make the change in scope.

12. In 1999, the IIA made a shift in focus and key authors behind this shift (Krogstad, Ridley, & Rittenberg) referred in their article to a statement from Wayne Gretzky: *I skate to where the puck is going to be, not where it has been.* This is an inspirational slogan, which in a different context could also be used by the IIA in the current area; the IIA might start using more academic research on forward-looking developments to be able to timely adapt and reprogram when and where required, rather than do so in hindsight. This could even lead to the question whether Gretzky was using the right puck to begin with! At present, there is limited Dutch academic synergy between the IIA and Dutch firms to perform fundamental research to bring the profession to the next stage and/or ahead off new developments.

### 7.4 Limitations of this research

This research also has several limitations. Firstly, it is explorative by nature and relies for a large part on the research of literature on *internal audit* and the *control of the firm*. It covers a broad overview on literature from different angles and with limited empirical focus. Its explicit purpose was to focus on this broader set of multidisciplinary views and theories as well, instead of testing one theory with empirical data. This limits the possibility of statistically proved generalizations; however, it provides building blocks for the theoretical basis of the field of internal audit.

\textsuperscript{81} Note: a risk & control function is not seen as an assurance function, as it supports management and does not provide internal assurance.
audit and a broader, multidisciplinary view on a control system of a firm. In addition, the exploratory approach is used to perform this fundamental research of integrative comprehensive perspective on internal audit and control.

Some empirical research has been performed in chapters 5 and 6, but there may be various parts that have not been empirically tested completely or with sufficient depth. In chapter 5, the existence of internal audit functions is investigated. These empirical findings should be interpreted in the right context, given the exploratory nature and relatively limited number of firms (61) taken into account. Future research on a larger scale is necessary to strengthen the results of this study. Cross country research could investigate the results in other countries as well. In addition, the current study has been performed on the basis on annual reports. There may be other relevant variables as well, such as the nature of work (manual labour, professional labour), role of technology and the application of IT within the different functions (a full enterprise system and the kind of business and business model that have not been taken into scope this time, as they require input from the organizations). Furthermore, there may be a risk of misinterpretation of information given the nature of the research by examination of annual reports and websites of the NYSE Euronext listed firms. Alternative research methods, such as interviews, may help to build on the results of this study.

There are also some limits to the empirical research in chapter 6. The results need to be seen in relation to the limited number of firms in scope (18). Future research on a larger scale is necessary to strengthen the results of this study. In addition, the current study has been performed based on interviews with internal audit functions and limited documentary research. There may be a risk of misinterpretation of information given the nature of the research. More in-depth research, possibly supported by questionnaires, may help to build on the results of this study.
7.5 Directions for future research

This study provides various possibilities for future research.

1. First of all, exploratory research has been performed on the existence of internal audit. There are some follow-up topics to be covered:

   a. Based on this study, certain firms are expected to have an internal audit function, but have none. It may be interesting to perform a more in-depth study on these firms, to discover why they do not have an internal audit function. The same applies to the firms that have an internal audit function while it is not expected of them according to the researched variables.

   b. In addition to the previous point, it may be interesting to perform future research on the existence of an internal audit function on a larger scale, to support the results of this study. Cross-country research could investigate the results in other countries as well.

   c. The current study has been performed on the basis of annual reports. There may be other relevant variables that have not been taken into scope in this research as they require input from the organizations, such as the nature of work (manual labour, professional labour), the application of business models and its effect on IT. Alternative research methods, such as interviews, may help to build on the results of this study.

2. Secondly, explorative research has been performed on the scope of internal functions, which leaves room for follow-up research opportunities:

   a. Research that includes interviews with Management Board and Audit Committee members to create discussion on the present and future scope of internal audit. Current dominant logic and belief systems of these members may not be in line with the developments in internal audit and its contribution to the control of the firm. This also provides the opportunity to align different vocabularies for the interpretation of things.

   b. This study already provides basic building blocks for the scope of internal audit functions, but these may be extended and be piloted at certain firms. Follow-up research can provide insights into possible attention areas and further extension of control elements to use in the scope of internal audits. This study can also include more in-depth study of the work programs related to internal audit functions to analyze the content of the different kind of audits.
c. This research touched on the resourcing of internal audit functions, e.g. the minimum level of employees or the minimum network of people (internal and external). More fundamental research is required on this topic.

d. Another interesting topic is the organization of internal audit and possibilities to integrate all assurance functions under the umbrella of internal audit. This from a cost / efficiency perspective (by preventing double activities) and from an organization perspective (overall, integrated view).

e. Furthermore, the integration of management and audit language and norms is an interesting topic that would bring the internal audit world and management closer together.