LEEN PAAPE

Corporate Governance

The Impact on the Role, Position, and Scope of Services of the Internal Audit Function

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Corporate Governance: De invloed op de rol, positie en taakopdracht van de internal audit functie

Proefschrift

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To Annette

CONTENTS

List of Appendices

List of Tables

List of Figures

Acknowledgements

As many PhD's before me will agree, it has been a long and winding road, with more ups and downs than I could have ever anticipated at the beginning. And that's probably just as well. Because if I had known what I was getting into, I probably wouldn't have gotten into it.

Have I learned much? Yes! Definitely yes! About Internal Auditing? After having been around the profession for more than 25 years and involved in teaching for more than 20 there weren't that many surprises. Nevertheless, I did learn much about New Institutional Economics, which increased my understanding of the rationale behind economics in general and auditing in particular. I've also learned a lot about research methodology. And the lesson that sticks out the most is that conceiving and carrying out sound, solid scientific research is not as easy as I had previously imagined. The same is true of audits, because auditing is nothing other than a subset of scientific research, which demands obedience to the same basic rigor and rules. I now know that many of my previous audits were, to put it mildly, less than perfect. So I guess I did learn something about Internal Auditing after all. And myself.

Having had the privilege of being active in both the business community and academia throughout my career, I have come to love the contrasts. Being able to incorporate real life experiences is essential for teaching professionals. Equally, keeping abreast with the results of academia is beneficial for real life. But it comes at a cost. Colleagues in the business world tend to look at me and shake their heads. "Why are you wasting your time at the university when you could be earning even more money out here?" And many hard core academics tend to see me as an outsider - not really "one of us".

Feet in two separate worlds, and at home in neither? Yes and no. Or, as we say in Dutch, *welnee*. I made these choices a long time ago, and nothing that has happened since has convinced me they are the wrong ones. In fact, I think more business professionals (and academics) should try it.

I would like to single out two very distinguished professors and role models for gratitude and appreciation. Bram Beek and Wim Hartman, who inspired and encouraged me to go down these anything but straightforward roads. From early on they shared with me their love of teaching *and* actively participating in the profession. They believed in me and helped me to believe in myself.

As for this thesis, there are many who have helped me along the way. First, I would like to thank the case study companies that allowed me to have multiple interviews with high ranking officers and provided many documents to supplement my findings. I would especially like to thank them by referring to their Chief Audit Executives who opened doors for me: Peter Diekman from ABN AMRO (now, sadly, front page news and about to be broken up), Gertjan Langelaan from Bank Nederlandse Gemeenten (BNG), Geert Gelling from the Informatie Beheer Groep (IB Groep), and Steve Youngman from TNT.

I wouldn't have started the PhD push without the efforts and encouragements of my former colleagues and the Management Board of PricewaterhouseCoopers. I thank them for their well wishing and giving me the opportunity to do it. True, I decided to quit the firm before the end, because the combined strains and stresses of being a full time Partner at the firm, Program Director at Erasmus University, working on my thesis, and, yes, being married and a father of 4 were taking their tolls. Having feet in two worlds is one thing, but everything has its limits. I thank my new colleagues at Protiviti Independent Risk Consulting for having me invited to become part of them. I also thank them for their patience during the last few months when I was struggling dotting the i's and crossing the t's. As of now my time constraints will be lessened.

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I have also had the assistance of numerous students who went way beyond the call of duty and loyalty. Hiske van de Broek became a three time revisiting aide. Eva de Mooij made many transcripts and helped me out professionally in many other ways as well. Jasper Bertels did thorough searches for appropriate literature and other materials. Natascha Buch helped me with the survey. Tim Berretty did a lot of number crunching. Our future is in good hands with young people like them.

Of course, my two promoters, Gert van der Pijl and Harry Commandeur, were indispensable. I thank them for pushing me to my limits and beyond, their patience in putting up with my frequently muddied thinking, and sticking with me when the going was so rough it didn't look like we were going anywhere. I also would like to thank Patrick Groenen, Professor of Econometrics at Erasmus, whose input for the survey was invaluable. Statistical calculus and surveys are not exactly my *forté*. I couldn't have had a better teacher. I would also like to thank Max Brecher, an American writer and teacher living in Amsterdam. He helped me out with grammatical, style and epistemological issues, and did what any self-respecting editor (and friend) normally does.

Last but in no way least, my most loved ones. They have suffered the most from my dreams and ambitions, but have never given up on me. If it weren't for my parents I would not have come this far. My father swam against the tide and sent me on for a higher education, because he was convinced I was worth it. My mother patiently cared for me, endured my whims, and let me to grow up without a care. Iris and Thomas, as a divorced father I suffered much from not being able to hold you, and know you suffered too. Putting in long hours to fulfill my overload of commitments didn't make things any easier. Lots of other kids have become angry and resentful with less real grievance. Thanks for not letting that happen to you.

Amber and Jasper, my children from my second marriage, I hope I've learned a few lessons to be able to better support you on your roads to adulthood. But I know this can't be taken for granted. That requires very deliberate and loving choices. My most overburdened loved one is Annette, my wife. She was the one who encouraged me almost 5 years ago to take up the offer and challenge PricewaterhouseCoopers provided me. You knew better than me what this was going to mean for our relationship. Nevertheless, you supported me, knowing that this was meant to be. Your love let me make that choice. I didn't grasp the real strain I put on you, and know I will never be able to thank you enough. But the good news is it's over now, and we'll have more time for just us.

Leen Paape,
June, 2007

Chapter 1 Introduction: Internal Audit: On the Rise?

1.1 Introduction: Bottom Line for Top Management

The speed of organizational changes, recent scandals – mega, mind-boggling fraud, embezzlement and book cooking - and the demands of shareholders, stakeholders and the general public for more transparency in how companies are run have led external supervisors and top managers to seek more assurance. Put simply, the concerned parties want to know about the quality and adequacy of internal control methodologies, systems and protocols for keeping abreast in semi real time of not only financial robustness, but also ethical and legal integrity. In the parlance of the audit trade, they want to know if they are "in control". And if not, what can be done to get back on track.

The assurance urgency – according to most observers, not yet an emergency – is accelerating because of stronger codes, sometimes seen as regulations demanding compliance, sometimes as recommendations suggesting it. For example, the US Sarbanes-Oxley law, rammed through Congress in 2002 in the ground scar of the Enron crash, and, for slower moving traffic, the Winter Commission's Report for firms listed on the stock exchanges of the European Union (to be discussed in more detail in Chapter 3). Sometimes it is the crack of the whip, and sometimes it is the mere shadow, but the bottom line is bleeding through with increasing clarity, frequency and legally binding specificity.

That is, in the not too distant future it may not only be lonely at the top, but also potentially dangerous for your health and mental and financial well-being. Gone with the whirlwind will be the days of a perk-filled life and, when things went horribly wrong, a simple "I'm sorry, I did the best I could" was good enough to silence the baying for blood shareholders and general public. Sooner or later - and in some cases right now - top management will be asked to certify that their entire internal control system is adequate. And if that proves to have been overly and unjustifiably optimistic, in some cases they will be held personally accountable in a more than metaphorical sense.

And it might not only be top management dangling before the cameras and getting gutted to appease the public's sense of payback. In January 2004 Enron's Chief Financial Officer (CFO) was formally charged with malfeasance and fraud and convicted to 10 years imprisonment. Ken Lay, the Chairman of the Board, died of a hart attack awaiting his conviction. Jeffrey Skilling, the CEO has been convicted to 26 years imprisonment. Bernie Ebbers, Chairman of WorldCom, also faced charges and got a whopping and record setting punishment of 25 years. Which means he will likely spend the rest of his life in prison. While his wife will be allowed to keep some savings, most of his assets will be taken away.

On January 6, 2005, one's day's fishing through several newspapers netted the following catch. *The New York Times* reported that 10 former WorldCom executives agreed to pay $18 million out of their getting shallower by the second pockets - not those of the insurance company - as a result of their malfeasance in the collapse of the company. The *Ondernemingskamer* - Dutch Court of Appeal for stakeholders in companies suspected of wrongdoing - ordered a large scale investigation into the sequence of events that almost wrecked Ahold. *Het Financieele Dagblad* reported that the *Autoriteit Financiële Markten*

(AFM), the Dutch version of the US' Securities and Exchange Commission (SEC), increased its staff to about 500 and its annual budget to € 70 million in response to the government's demands for their services.

Thus there are problems. Or, if we prefer the more positive classifications of engineers and managers, "challenges" and "issues". And, as is demonstrated by the increasing number of sudden and spectacular crashes – previously high flying and even flagship banks and companies, such as BCCI, Barings, Enron, Worldcom, Tyco, Rite Aid, Global Crossings, Ahold, Parmalat and Shell – current control methodologies, systems and protocols aren't up to the job. You could say that we have a situation. "Houston, we have a problem!"

Some might contend that the answer to the question, "Are we in control?" is "Are you kidding?" Others would call that hysterical doom glooming, alarmist orange and red alerts. Blips on the screen magnified into full battle dress panics by a sensationalism mongering media. The bottom line is that the basic body of the capitalistic system - and the companies functioning therein - is healthy, and if it ain't broke, don't fix it.

Who is right? I don't know, and neither does anyone else. But one thing remains unproblematic. With so much at stake, all the main players will hunting for assurance on the actual state of not only companies, but also, in some countries (The Netherlands, for example), government programs. The more the better.

That's the demand. But what about the supply? In the words of the catchy song from another film, *Ghostbusters*, "Who ya gonna call?" Management consultants? Economic forecasters? Futurologists? Trend gurus. The Delphic oracle? Or, as this study contends, someone much closer to home. In fact, in house. That is, Internal Audit (IA), also known as the Internal Audit Function (IAF), or Internal Audit Department (IAD).

At first and second glance, a solution to some of the problems mentioned above seems anything but self-evident. Why not? Because IA itself is not traditionally self-evident. Many organizations don't have them. And even those that do often wonder why. What does it do? What can it do?

Nevertheless, there are many organizations that do have IA. And even though they can't immediately put their finger on exactly why, they wouldn't be caught dead without it. What's more, and probably more due to current corporate governance (Corporate Governance) directives than perceived inner need, many more companies will be having them in the not too distant future. All of this points to some needs that IA satisfies, however vaguely those needs may be stated and, possibly, however inefficiently IA may be used.

This research is intended to make practical contributions to not only how organizations are run and monitored, but also societies. How so? Because since the well-being of our societies depend to a large extent on the state of health of the organizations that drive the economic engines, improvements in the later will be impact the former.

Considering the enormity and intricacy of the big picture and the, up to now, relatively trifling status and role of IA, such a contention might sound uncomfortably close to the proverbial mouse that roared. Or, special pleading - even lobbying - and a case of what many would consider a niche issue trying elbow its way onto center stage. There might be some truth in those perceptions. Nevertheless, remembering the words of Albert Einstein - "If at first the idea is not absurd, then there is no hope for it." - it is a subject I deem worth exploring at some length and in some depth.

1.2 Legitimating, justicification, and some preliminary notes

The scientific rationale for this research is that the number of research that has been carried out regarding IA is limited (see Chapter 4 for details). There is a need to further that because this will allow us to substantiate the rationale for Internal Audit and provide insights for the phenomenon of Internal Auditing.

From a societal perspective there is also a need for research like this. Organizations are very important institutions from an economic perspective as well as from a sociological perspective. There is great interest lately in the governance of organizations, mainly due to a large number of corporate scandals that shook public trust. Auditors, both external and internal, are regarded as a resort that might help to prevent corporate scams and thereby help to restore that public trust.

From the perspective of practitioners there is also a need to further research. Many practitioners are confronted with compelling questions around Internal Audit. Why do we have an IAF? Should we have an IAF internally or buy it from a service provider? How large should it be? What should the Scope of Services be? All questions that are in need of conclusive answers instead of answers provided by rules of thumb.

To be able to position this research New Institutional Economics (NIE) was called to the fore. NIE models institutions and economic behaviour (see for a more elaborated discussion Chapter 4). Williamson provided the following diagram (1998, 26 and 2000, 597):

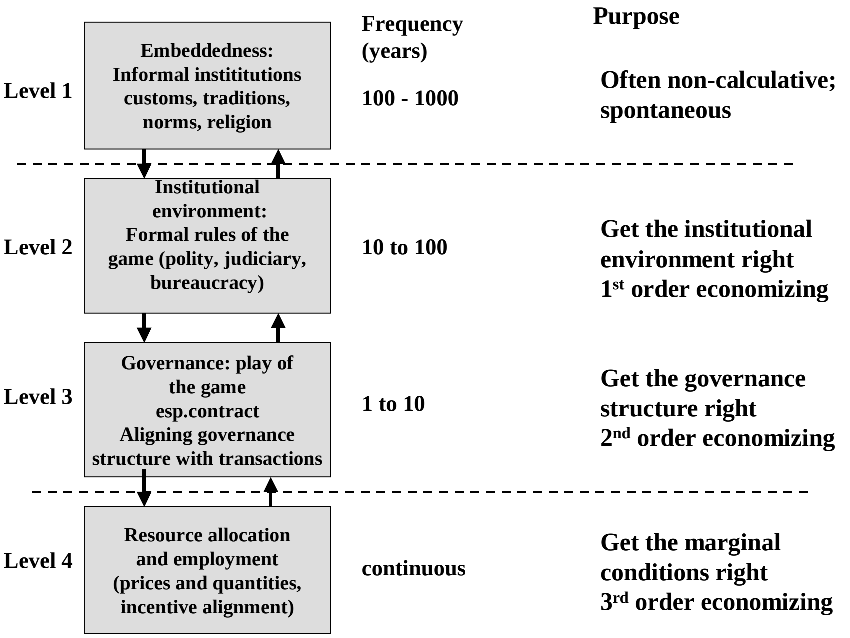


Figure 1: Applicability of New Institutional Economics

These levels can be explained as follows:

- Level 1: Social Theory: This is the level at which norms, habits, and traditions are established. The frequency of change is low, once every century to millennium. This level will be treated here as exogenous.

- Level 2: Economics of property rights: Williamson calls this the institutional environment in which organizations function. Contract theory is a resultant, which has major impacts on how organizations function. The assignment of property rights is advantageous for individuals - incentives - and thereby influences their behaviour. Changes take place once every decade to a century.

- Level 3: Transaction Cost Economics operates on this level. Transaction costs are those incurred searching for and gathering information, negotiating and deciding, supervision, and enforcing a contract. The main issue is that some contracts are such that verification of compliance is (nearly) impossible, thus making court enforcement also impossible. This means that there is a need for self-enforcing commitments. Williamson pays attention to this within the framework of Transaction Cost Economics, where the main problem is which governance structure should be chosen. Changes take place over a period from one year to a decade.

- Level 4: This is the level of the marginal analysis and focuses on deciding on the right incentives under certain risk levels. Neoclassical theory and Agency Theory are applicable at this level. Agency Theory deals with "Information Asymmetry" (see below) between parties to a contract and the problems of assigning - especially *ex ante* – incentives to prevent *ex post* trouble. This is a continuous process.

The arrows in the diagram pointing down indicate the restraints that a higher level places on the level just below. The arrows pointing up indicate feedback. The model is dynamic in the sense that there are connections between the different levels. But it seems that with every advantage come disadvantages. In this case that is the impossibility of testing the full model, because, given the time lines, that would take at least a millennium.

According to Williamson, New Institutional Economics focuses on levels 3 and 4. Agency Theory and Transaction Cost Economics are theories that slot into New Institutional Economics. While New Institutional Economics sees the firm as a nexus of contracts (Furubotn and Richter, 1998, 152) though, Transaction Cost Economics sees it as a governance structure.

As we will discover in Chapter 4, where we explore in considerable detail and depth two major contenders stemming from NIE for explaining the why and what for of IA: Agency Theory and Transaction Cost Economics. This research is therefore focussed at level 3 and 4.

Agency Theory developed in a climate where the divide between ownership (principals) and management (agents) was getting wider, and it was becoming increasingly more important, and difficult, for the former to know what the latter was doing and, in many cases, even why.

In Agency Theory terms, this is called "information asymmetry", and revolves around the principals' fear that they are being cheated

Transaction Cost Economics sees many of the operating expenses of organizations in terms of transactions. Transactions occur "when a good or service is transferred across a technologically separable interface. One stage of activity terminates and another begins." (Williamson, 1985, 1) The expenses incurred in such transactions - which include searching for parties to contract with, collecting information, negotiations, drafting contracts, and monitoring the fulfillment of contractual and other agreements - are called "transaction costs". Considering that some (Arrow, 1969, 48) have characterized these as "the costs of running the economic system", and others (Furubotn, Richter, 1998, 39) have estimated that they make up 50-60% of the US Net National Product, this is more than chump change. Transaction Cost Economics is about keeping these costs as low as possible.

In other words, both theories have been developed to deal with issues other than IA. And while they might be full-blooded and -blown as far as their original objectives are concerned, they are somewhat sketchy and end of the pipe in their application to auditing in general and IA in particular. So why have we selected them for our tasks?

That is, Agency Theory and Transaction Cost Economics may not be much of theories about auditing - and this comment is by no means to be interpreted as a slur on their successes and validity in their own areas of expertise - but they are the only viable ones we have. As far as I know, Agency Theory is the only theory used in the literature to deal with the justification for auditing in general and, in a handful of papers, IA in particular. Transaction Cost Economics is also occasionally also applied to IA.

The reason is that to some extent they do have explanatory and predictability power for some of the issues we will be dealing with. For example, Agency Theory offers explanations of the rationale of IA. And Transaction Cost Economics offers starting points for determining IA's scope of services, and a foot in the door of the "make or buy" issue.

Let's now take a look at the bigger picture. That is, IA's position in the scheme of things. As we have indicated above and will learn more thoroughly below, in most business environments IA is exclusively in the hands of the Management Board. Or, in a one-tier system[1], the executive management side of the Board of Directors.

In Agency Theory terms, executive management is for all intents and purposes the principal and IA the agents. IA has been, and to a large extent still is, controlled by the principal, and that has had a major impact on its scope of services. But that is hardly the whole story. Quite often, the Management Board didn't understand the exact purpose of IA and what to do with it, and, therefore, had a rather ambivalent attitude about the whole phenomenon. On the one hand, they were extremely "helpful", coming up with detailed findings about what was happening within the organization. But, on the other, they were also a nuisance. Because they were placing those findings on the Management Board's already overcrowded plates. In many cases, the findings were hard to swallow, and even harder to digest.

[1] In a one-tier system executives and non-executives "supervisors" meet in one board. In a two-tier system management executives meet in a Management Board (Management Board, or its equivalent) and non-executive "supervisors" meet in a Supervisory Board. This will be further elaborated in Chapter 3.

As we will discover in more detail in Chapter 2, there are variations on the themes of not only what IA is, but also what it does, where to find it, and even what it is called. And variations on those variations. For example, sometimes IA is decentralized, subdivided into subunits, and very much in the hands of lower (or line) management and just about anyone else who can get their hands on it. And IA, "like an unloved dog in a poor family" (in the words of the late Canadian economist John Kenneth Galbraith), has a conditioned reflex to wag its tail and try to please as many people as is humanly possible. Or perhaps more than is humanly possible.

There are situations where IA is not even "internal". That is, it is either completely or partially outsourced. There are situations where it isn't called IA, but, rather, is given another nomenclature. Thus while IA may look like a simple enough description, it teems with subtext. More specifically, IA is a collective noun that includes some or all of the following actors and activities:

- Registered Operational Auditors (RO's), who audit Management Control Systems. This is sometimes known as Management Control Auditing. They also do operational audits. That is, monitor how the processes and/or organization operate;
- Registered Accountants (RA's), who perform financial audits. This is where the reliability of the financial reporting is checked;
- Registered EDP Auditors (RE's), who do EDP audits. That is, monitor the reliability of information systems;
- Multidisciplinary Teams doing integrated audits. That is, integrating all the above audits into an integrated whole;
- Certified Fraud Examiners (CFE's), who perform fraud audits. As the name implies, these are carried out to see if fraud is happening within the organization. And if so, where and how much?;
- Compliance Auditing: checking to see if practices adhere to the latest regulations and legislation.

But that is hardly an exhaustive list. Some organizations might have quality-, safety-, environmental-, and/or technical-auditors.

In order to make things simpler than they should be, however, we will exclude many of the variations and focus on IA "*als of*" - as if - it were a single unit working at the highest levels of an organization. That is, just below the Management Board or its equivalent.

But this cozy and confidential relationship - sometimes love-hate, sometimes "functioning perfectly well" - is currently opening up, expanding and becoming more like a *ménage à trois, ou quatre, ou cinq*. In other words, there are more players and more dynamics to manage. These players and their relationships are depicted in Figure 2.

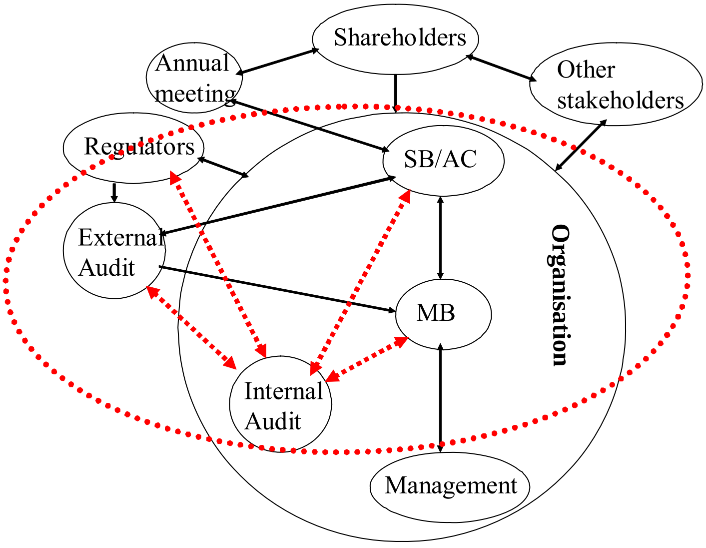


Figure 2: The context of internal audit

In order to simplify the picture, let's break it down and parse it out. The shareholders provide equity and, in a two-tier system, appoint the Supervisory Board at the annual meetings. They, or at least the more important among them, are demanding more transparency and accountability. The Supervisory Board appoints an Audit Committee to supervise and monitor the organization's accounting and auditing processes and financial results. The Management Board is top management, which uses many tools to keep an eye on lower management. Among them is IA, whose Chief Audit Executive (CAE) also has a working relationship with the External Auditor.

In addition to these players, there are also regulators, which, especially in the financial services sector, impose strict rules and regulations on both IA and External Auditor. Then there are other stakeholders that have an interest in the well-being of the organization. For example, employees, or the general public in places where that organization is one of the main economic support systems in a village or region.

In this research we deal only with those players contained within the red dotted oval. The research object is IA and those actors that exercise a direct influence on its functioning. Regulators such as *De Nederlandsche Bank* (DNB, the Dutch Central Bank), the *Pensioen- en Verzekeringskamer* (PVK, the supervisor for pension funds and insurance companies), and the aforementioned *Autoriteit Financiële Markten* (AFM) were interviewed and their regulations and recommendations included. Other regulators that are internationally relevant were studied only via reading the relevant publications and regulations. This explains why they are not placed within the red oval. Other "participants", such as stakeholders other than shareholders and lower management are also excluded.

While these stakeholders might have a direct impact on supervising and governing bodies, their impact on IA is indirect. Their influence is exercised via regulators and shareholders – or, in the case of governmental organizations, stakeholders - and trickled through to IA. Lower management is excluded for the same sorts of reasons. Because they don't have direct influence on establishing the Audit Charter, which defines IA's position, role, and scope of services. And, in Agency Theory terminology, they do not have a principal-agent relation with the IAF.

The changing needs of shareholders, expressed in regulations such as Sarbanes-Oxley, VBTB (*Van Beleidsbegroting Tot BeleidsVerantwoording*[2]), and the Corporate Governance Codes[3], has led supervisors, such as the Supervisory Board and the Audit Committee to spread their wings over IA and meddle with its scope of services. According to some of these codes, these supervisors should supervise internal auditors, be involved in the appointment and appraisal of the CAE and have meetings with him without the presence of the Management Board. I envision that Corporate Governance regulations will create a need for the Supervisory Board and Management Board to adjust the Audit Charter to suit these changing conditions. This change can have consequences for the relation of IA and its CAE with most parties involved: the Supervisory Board, the Management Board, management, and the External Auditor.

In other words, while up until now the Management Board has, in many cases, been IA's sole principal, in the near future it might be sharing this "mastership" with the Supervisory Board/Audit Committee. In some instances, the Management Board might be bypassed, and the contract (in the form of the Audit Charter) with IA might require the input of the Supervisory Board or, at the very least, its consent. That could mean that IA might be tasked to monitor not only lower management, but top management as well. While the former job has been the mainstay of the profession for as long as most people can remember, the latter is very much *terra incognita*. This will have consequences for the contract that is created and the scope of services stipulated in this contract.

Not to mention other spin-off effects, which in some aspects, might be highly beneficial, and in others might be disastrous. In order to understand how that might play out, we have to realize that different actors within the organization have different needs, and these needs can often conflict. For example - again in Agency Theory terms - principals seek assurance about the activities of their agents and the reliability of the information they receive from them. Agents, such as lower management, need help and advice about their problems. About, say, how to increase efficiency - to give it a positive twist - or reduce inefficiency and sheer waste. Principals may wish to know some things - especially when things aren't going according to plan - that agents would prefer to keep hidden.

In a re-alignment of traditional roles the pivot point - center of gravity - will no longer be in one place only. That is, IA will be providing assurance not only to the Management Board, but also the Supervisory Board/Audit Committee. The traditional receiver of audits will also become a subject of them.

1.3 Research Questions

All of the above have led to the following core research question.

[2] VBTB is intended to create more transparency and accountability in government, and is relevant to Corporate Governance initiatives in the private sphere. VBTB aims at strong linkage between approved budgets and plans and actual results achieved, which should be detailed in the annual report.
[3] See Chapter 4 for a more extensive elaboration.

- ❖ How have Corporate Governance regulations affected the position, role, and scope of services of the Internal Audit Function?

This core research question needs to be more detailed to allow proper research. The first step was to research what is meant by a function. An analysis of relevant literature showed that the concept of an organizational function is scarecely defined:

> The concept of organizational function is scarcely defined in literature and the word function is used in several kinds of contexts with different meanings. (Aveiro et al, 2006, 1-2)

Alveiro et al (2006) refer to Kampfner, who describes functional subsystems in three binary relations: (1) the subsystem relation, that relates a functional subsystem to its parent system; (2) a controls relation (who controls it?); and (3) the reports-to relation (who is the boss?). In their paper they develop these ideas further and describe a number of functional artifacts such as (a) goals (what is the rationale of the functional subsytem? what does it contribute?); (b) business rules (which activities does it perform?; how is it controlled?); (c) exceptions and error dynamics (which processes are available to deal with exceptions and errors to be adaptive? therefore you need to know how it is controlled). A function also interrelates to other functions and other organizational participants. We have to keep in mind that their endeavour to develop an ontology of organizational functions focussed primarily on the information systems environment.

Although Alveiro et al (2006) provided some clues, their contribution was not conclusive enough. Keuning and Eppink (2004) described a function as a coherent set of tasks, responsibilities, and authority. A function provides a common goal for the activities undertaken. Furthermoe, they mention (213-214) that a function should explicitly state its contribution to the organization. It also requires an understanding of the relationships it has with others, also outside the organization.

With the above in mind I asked myself a number of questions to define the attributes of the IAF that needed to be researched. First of all the question comes to mind that there needs to be a goal, a rationale to have IA activities performed in the first place to install an IAF. Based on my knowledge of organizational theory (see Chapter 4 predominantly) I know that if there is a need for IA activities, the question is how to get them? One can buy them of the shelf from a third party (‘buy’) or one can decide to integrate them into the organization (‘make’). If the latter is the case, the issue will be where to position it in the organization. Looking at Figure 2 the Management Board and the Supervisory Board are the most likely candidates to report to. If one has decided that there should be an IAF, the next question will be how large it will be. If that has been decided upon, we need to think of how to control this function and make it work properly. Next there is a need to define the specifics of the activities; what does it exactly need to do and what does it contribute? Given the specifics of the IA auditing activities and the natural relationship of the IAF with the external auditor, we need to look at their relationship as well.

Thus, in some more detail the core research question leads to the following questions.

- ❖ What is the role of IA? Why does IA exist? What is its *raison d'être*, or, as some would put it, its "license to operate"?

- What are the considerations for the "make or buy" issue for IA (in-source or outsource)?

- What position can it have within the company? That is, what can its relationship be with the Management Board and Supervisory Board/Audit Committee? And in a conflict between those two, which relationship could have precedence?

- How large can it be?

- How can IA be controlled?

- What can it do? In other words, what is its scope of services?

- What is the relationship with the external auditor?

This is depicted as follows:

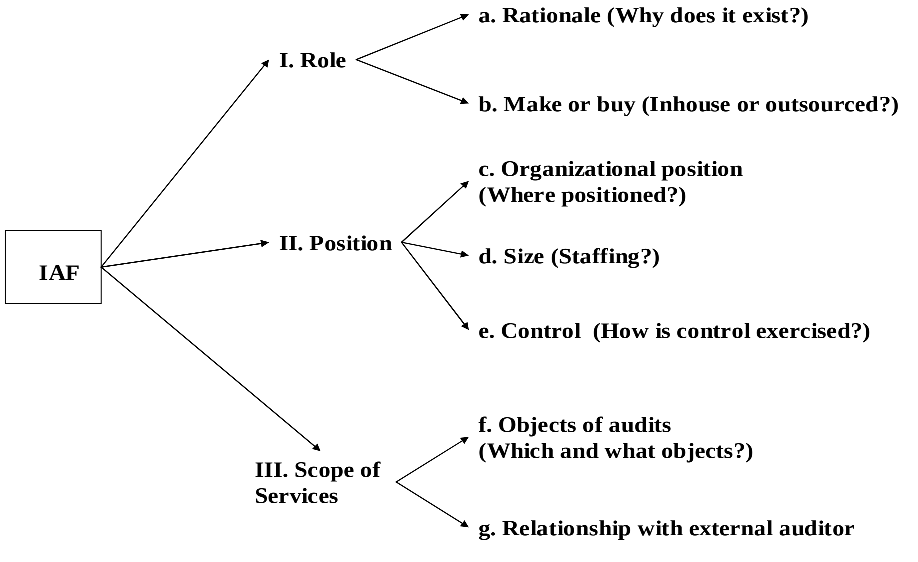


Figure 3: Scheme for researching the Internal Audit Function

This scheme is used throughout the remainder of this thesis. Again, the aim of the research is to look at what has changed in the above aspects during – roughly - the last decade when a number of Corporate Governance regulations came into effect.

1.4 Research Approach and Methodology

With these questions in mind I read numerous publications on research methodology. One of the more useful books for me was one written by Johnson and Duberley (2000). They provide some essential insights and an excellent overview for a better understanding of the matter.

They underpin the importance of epistemology - knowledge about knowledge. It aims at providing a basis and criteria to distinguish real science from pseudoscience. This research is based upon the positivist perspective.

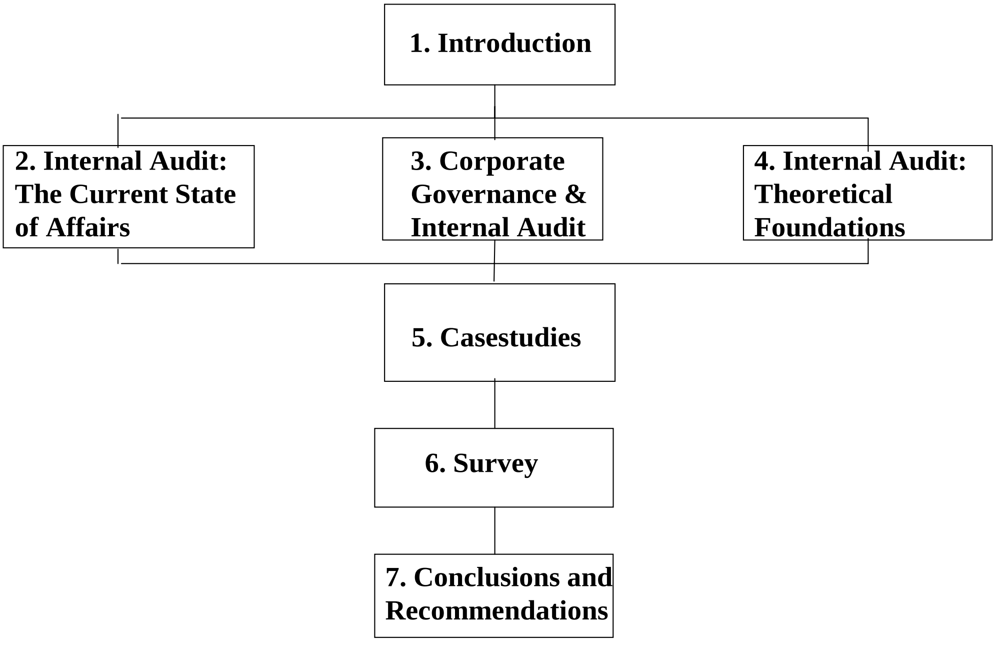
Research like this is aimed at furthering theory, in this case theory around internal auditing. Before starting off, we need to create a starting point by taking stock of the current state of affairs of IA. Next to that we need to elaborate the developments around Corporate Governance during the last decade and look at the changes that might have affected internal auditing and it’s relationships with parties in the governance domain. Following that, we research Agency Theory and Transaction Cost Economics, their applicability to IA, and search for clues that could further theory.

Since theory development with regard to internal audit is relatively limited, as will be shown in Chapter 4, this research uses explorative case studies to describe "facts" and further theory development through generalizations from empiricism (Yin, 1994, 2003). Based on that research I developed a number of preliminary "conclusions" to use in the case studies. Preliminary because the “conclusions” that were derived from existing theory were not conclusive and in need for further support by real life facts. I then turned to four case studies. The rationale was twofold. One, to check if the predictions that could be gleaned from Agency Theory and Transaction Cost Economics - limited as they were - had actually happened, or were happening. Two, to supplement existing theory with additional information in an attempt to generate some revised generalizations and hypotheses. The case studies were thus used to further amplify theory and the results were used to develop a survey. The survey was mainly developed again to explore and describe "facts" but a few hypotheses to be tested were also included. The rationale behind case studies and the survey will be elaborated in, respectively, Chapters 5 and 6.

Considering the near absence of theory specifically applicable to IA, this research can't be anything other than exploratory in nature. Given the plea entry - under special circumstances - I am, nevertheless, attempting to sharpen the discussion by at least starting to find and ask some of the right questions, even if I can't answer most of them. And I would like to at least show how some of the results of this research could then serve as ingredients - nothing so grand as building blocks - in a theory that can be tested empirically, challenged and refined. A theory that could go some way toward helping the internal audit profession to adequately define and defend itself in these changing times. And for those making use of its services - the Management Board, Supervisory Board/Audit Committee, and, possibly, others - to know a bit more about what it is capable of and should be doing. In the right climate and hands. And, equally importantly, what is better left in the hands of others.

1.5 Overview of the thesis

This thesis is structured as follows:



Chapter 2 demonstrates the state that IA is currently in and makes a case for attempting to get more of a grip on the situation through, first, recognizing and acknowledging that there are structural problems - not incidental ones that can be fixed with a patch here and a bit of superglue there - and, second, more overview and deeper insights.

Chapter 3 explores the developments in Corporate Governance rules and regulations over the last decades, both internationally - that is, in the US, UK, and EU - and in The Netherlands. Compared with the versions that came to light some decade ago, IA has made significant progress. It is mentioned and specifically addressed in many of those reports.

Part of being prepared means having solid theoretical ground under its feet for the judgments it is making. Chapter 4 explores the possibility of casting Agency Theory and Transaction Cost Economics in the roles of IA's knights in shining armor, which can provide some useful insights.

Chapter 5: After discovering that our chosen theories are much better in supporting roles than as main players, we carried out four case studies. This Chapter presents the rationale, methodology, results and discussion of them.

Chapter 6 covers the survey - constructed out of the predictions and results derived from the two theories and four case studies.

Chapter 7 sums up the entire thesis, comes to a few conclusions and makes recommendations for further research.

Chapter 2: Internal audit: The Current State of Affairs

2.1 Introduction

In order to be able to assess whether there is a gap between the current and the desired role, position, and scope of services – the is and the should – stock has to be taken of its current role, position, and scope of services and compared with the optimal pathways suggested by a combination of theory and best practices. If this exercise is carried out, then the profession as a whole will be able to gaze into the crystal ball and see a series of possible futures. And by doing so, professionals will be able to make deliberate choices and help steer events rather than, once again, being steered by them. A conscious and contributing player in the game of what happens next rather than a pawn subject to the whims and mood of the moment of whomever happens to be at the helm of Internal Audit at any given time or location.

There is lack of consensus about definitions, job descriptions, what to do, and what not to do, and for whom, measures of success and failure, what steps to take, or things to disagree about, is part and parcel of the chaos. It might not actually be the *fons et origo* of the chaos. But it certainly does help to keep it going.

In the second section we will look at what (internal) audit is all about. In the third we will take a closer look at what constitutes an internal auditor. Sections 4, 5, and 6 will deal with the issues of Role, Position, and Scope of Services as depicted as a generic scheme for the entire thesis in Chapter 1.

2.2 What is (internal) audit all about?

History

When in doubt about the logic and justification for any decision, history is a good place to start. Check the archives and look for patterns. When available, theories, that will show how it all fits together. Don't, unless you absolutely have to, invent the wheel.

Most (1969), for example, describes auditing practices that go back to ancient Babylonian and Egyptian civilizations. Brown (1968) gives an idea of how things were handled in the latter.

> Nothing was given out of the treasury without a written order. Peculation on the part of the workmen was provided against by the records of one official checking those of another. When the corn was brought to the storehouses each sack was filled in the sight of the overseer and noted down, and when the sacks were carried to the roof of the storehouse and emptied through the receiving opening the scribe stationed there recorded the number received. (1968, 21)

Ramamoortie (2003) gave an overview of the history of internal auditing and goes back as far as 4000 BC! Formal record keeping systems were instituted to allay concerns about correctly accounting for receipts and disbursements and collecting taxes. Ramamoortie describes the similarities in developments during the Zhao dynasty in China - around 1000 BCE - and public finance systems in Babylonia, Egypt, Greece, the Roman Empire, city states in Italy, etc. All of them developed a detailed system of checks and counterchecks.

But auditing wasn't concerned only with numbers. How many sheep there were in a flock, and how quickly they were going forth to multiply. Or the amount of grain in the state barns. Auditing was also involved with psychological-sociological-moral issues. Writers such as John Cassian (fifth century Gaul) wrote about the need to eradicate secret "hiding places" (*laterbrae*) and make monks totally transparent to themselves, their fellow monks and superiors, and God.[4] Are you true to yourself? Are you who you say you are? Does the apparent tally with the real, the rhetoric with the reality?

In medieval times another example can be found: the *circator*, or roundsman, who night and day policed the corridors of Benedictine monasteries, on the lookout for inappropriate "hidden" behaviour among the monks, including, "lingering with intent".

> "The roundsman was a product of this age of selective amalgamation. The office seems to have originated during the eighth century when the circumstances at some monasteries necessitated that the general duties assigned to the senior monks in the rule of Benedict be divided among more specialized officials. The paucity of evidence for the internal life of cenobitic communities in this period makes it difficult to determine with certainty what kind of circumstances resulted in such a reorganization of the monastic infrastructure, but it is most probable that the population of monasteries grew large and unmanageable. Whatever the reason, some legislators of this period found it necessary to create new officials endowed with more precise duties. The duty of making patrols or rounds of the monastery to supervise the brethren fell to an official most commonly known as the *circator* (and more rarely as the synonymous *circa* and *circinnator*). The title clearly indicates the primary function of the office: to make the rounds of the monastery (*circumire monasterium*)."[5]

When things were simple, the abbot himself was solely responsible for seeking out "intimate enemies". That is "enemies" not on the outside, where one would expect and watch for them, but those lurking within the organization. But as monasteries expanded physically and became a warren of buildings, ill-lit corridors and nooks and crannies, he could no longer do this on his own. Therefore, he had to delegate these responsibilities to his snoop patrols, the *circatores*, who noted breaches of monastery rules and reported them back to him. Nowadays, we would call this notion an "agency problem". We will return to this point in Chapter 4.

Why need audit?

Some clues have been hinted at in the above. It is not always possible to oversee what is happening on the premises - e.g., temples, estates and monasteries. Therefore, complexity and scale seem to foster the need to have some kind of an auditor around.

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[4] David Brakke, "The Problematization of Nocturnal Emissions in Early Christian Syria, Egypt, and Gaul", *Journal of Early Christian Studies*, 1995.

[5] Scott Bruce, "'Lurking With Spiritual Intent': A Note on the Origin and Functions of the Monastic Roundsman (Circator)", *Revue Bénédictine*, 1999

Another factor might be the need to verify information and interpretations in messages and reports that one relies on to make important decisions. Is it true? False? Somewhere in between? Accurate? Exaggerated? If those relying on these messages and reports have neither the time nor the ability to verify the contents, they will obviously need someone else who does. Thus an allegedly more independent and objective function will evolve "organically", out of perceived internal demands. If this is the case - as it to a certain extent has to be - such a function will depend on its "credibility".

What does that "credibility" depend on? Or, put differently, what does it consist of? Obviously, the ability to assess the correctness of the above-mentioned "information" and "interpretations" of it. But how does one assess the ability to assess, or the lack thereof? What are the measures? Guidelines? For the present, let us assume what most people are already assuming - at least until things go terribly wrong - that these abilities are a given and everyone knows and agrees about what they are.

Another ingredient in the credibility debate is being able to do the job effectively, economically efficiently, and in a timely manner. How does one assess "effectively" and "economically efficiently"? Both would have to include knowing what to focus on, when, for how long and in what breadth and depth. And, obviously, knowing what not to focus on, or generally skip over. In other words, having a sense of perspective, knowing what's important, the difference between center and periphery, essence and accident.

How does one separate the wheat from the chaff, core issues from blips and happenstance? And while resolving them is hardly more than a distant dream, pointing in that general direction normally involves some bold attempt at overview and mapping. In other words, some kind of theory, however flawed, that permits some kind of value charting. In our case, that would mean a useful theory about what audit is and how it works.

Definitions

A quick sampling of numerous definitions of audit making the rounds demonstrates that it is difficult to define. Mautz and Sharaf (1961), Silvoso (1972), Mautz (1975), Flint (1988), Paape (1999), Kocks (2003), Paape, Otten, De Korte (2005) are just a few of those rushing in where wise men fear to tread.. The first quoted here comes from Mautz (1975)[6], reproduced by Flint (1988).

> The role of auditing in an advanced economic society can be and has been stated in very simple terms – to add credibility to financial statements.

This definition briefly reflects what the function of an audit is. Namely, adding credibility to (financial) statements. One could argue that you cannot add credibility like you toss mayonnaise on the salad. The credibility is organically derived from the fact that a trusted party, having assessed the reliability of the facts and numbers, states the same with his consent. A further interpretation of the requirements for an efficient realization of this objective is not taken into consideration by Mautz or by Flint.

[6] R.K Mautz (1975), "The role of auditing in our society", unpublished background paper for the AICPA Commission on auditors' responsibilities. See also Flint (1988, p. 6).

While the definitions reflects back on what auditing is supposed to be doing – and probably also contain a huge, smuggled in cargo of ideology and other agendas – the sheer number of them forces us to ask, "Are there more dissimilarities in the definitions than similarities and overlaps?" In other words, while it may be convenient to speak and write about audit as a whole, is it meaningful? Does it conceal as much as, or more than, it reveals? The fact that so many definitions exist indicates that it often involves attempts to indicate "what it *could* be".

Power (1997) states:

> Definitions are more an idealistic, normative projection of the expectations from practice. As a consequence of this diversity the expectation gap has only widened. It is a product of the vagueness of the objective [that is, definition] and scope of the audit, which is also founded by numerous research committees.

The literature discussing methods and the process of auditing grew slowly over the years. Little attention was paid to the development of specific audit theories. Generally speaking, the concept and underlying auditing philosophy was taken for granted for a long time. Probably too long. More recently, there have been attempts to come to a universal theory around auditing. In other words, to audit auditing.

Like unified field theory, this theory would - so they said - would transcend all the possible variations of any particular audit and demonstrate what they have in common. In other words, it would be applicable to all audits insofar as they are audits. As such, a mighty contention. But, nevertheless, one adhered to by a number of researchers. For example, Wilschut (1994) and Kocks (2003).

Mautz and Sharaf (1961) and Flint (1988) – all three representing the External Auditor (external audit) community - have taken some important first steps. Silvoso (1972) reported on the results of the Committee on Basic Auditing Concepts. The International Federation of Accountants (IFAC) report (1999) later built on the basic framework developed by the Committee. Wilschut (1994) has also indicated what elements should be contained in a "general theory of auditing". He noted that:

- There should be an assignment to carry out an audit.
- The subject matter should be derived from the assignment.
- Audit objectives need to be defined.
- The audit criteria (when will the audit objectives be met?) should then be established.
- There should be a clear formula about how to come to a conclusion.
- Methods and techniques should be used to come to that conclusion.
- A risk analysis approach should be used.
- Interrelationships between all the aforementioned subjects should be analyzed.
- Professionals should be subject to a professional code of conduct and ethics.

Such elements as expertise and reliability are not mentioned. Flint considers the fact that the definitions omit some elements as irrelevant, because the true objective of an audit in these (and all the other) definitions is still lacking. This does not imply that all these elements are unimportant. "Lending credibility to financial statements is only one manifestation of the social function of auditing, although, no doubt, a very important one." All the abovementioned definitions lose sight of what he considers to be the ultimate objective of an audit. That is, providing an opinion about the behaviour of the actors involved in relation to the ruling cultural, social, political, and ethical standards.[7]

Thus the basic concept and idea was that audits should contribute to the reliability of the information provided, in most cases via the annual report and the published accounts. Silvoso (1972) has been shown that this is not an easy undertaking. When chairing the Committee on Basic Auditing Concepts he wrote:

> Fortunately, the profession has realized that the auditor can never assert the fairness of financial statements as true. He cannot even assert the truth of many minor propositions from which the fairness proposition is inferred. *Some* propositions are evident to the auditor because they are proven observation statements. *Many* propositions, however, are evident to the auditor because either he has postulated them or he has confirmed their validity. Thus, the distinction between empirical truth and validity is an important one in any inquiry. (1972, 39)

With regard to the level of credibility:

> We realize, of course, that modification of the auditor's opinion to include a degree of credibility will require many years, if indeed it can ever be accomplished. (1972, 42)

Professional auditors speak about "reasonable assurance" without specifying exactly what reasonable is. Of course what is reasonable depends on the situation and, therefore, is contingent and somewhat fluid. One of the often quoted defense mechanisms of auditors is to drag in the "professional judgment" *deux ex machina*. That's something professionals make judgments about. And even if the amorphous public can't understand what that silly putty means - and, let's face it, they can't - they still could be convinced by it. But if financial scandals occur too often, the "professional judgment" mantra will inspire more disgust than confidence.

Power had some strong opinions on this subject in 1994.

> Audit is a particular manner of (re) presenting administrative problems and their solutions, one that is becoming universal.... In place of proximity of control, such as in supervisory practices or real time inspection, audits function at a temporal and often spatial distance from the organizational processes to which they are applied. (1994, 299-300)

[7]Flint (1988). On page 15 he defines an audit. On page 13 he talks about the objectives of audit: "compliance with specified norms of what is acceptable behaviour, it is clearly culturally, socially and politically dependent".

Power (1996) was clearly worried that the audit concept might become so pervasive that it could be seen as the magic potion Asterix swallows to become better than he is, or even should be. A perceived - rather than a real - fix for all problems. "Hey, you have this issue. No problem. Audit it." In his article, "Making things auditable", he warned:

> Making things auditable is a constant and precarious project of a system of knowledge which must reproduce itself and sustain its institutional role from a diverse assemblage of routines, practices and economic constraints. It is when this knowledge system extends its reach into new areas that this project, and the logic of auditability, which requires facts for its procedures, is most apparent. (1996, 312)

Examining the consequences of such laws as the US' Sarbanes-Oxley (elaborated in Chapter 3), it seems that his worst fears could come true. In this law the urge to make things auditable is pre-eminent, perhaps even screamingly so. And one doesn't have to look far for the motivation for such red alert concern. In the wake of frequent, costly and very public business scandals, governmental regulators and the public at large want to assurances that something meaningful and effective is being done to punish the guilty parties, and, more importantly, to ensure that these sorts of thing "never happen again".

Classification

But what can assurance and/or credibility be provided about? Over the years the number and diversity of audits has increased and numerous variations have been created and tweaked. Auditing has become a fleeting concept, a moveable feast. Audit practices are anchored in developed capitalistic societies and the trend over the last 15 years is that auditors are elbowing their ways into regions, some of which are already occupied by other professionals. And some of those other professionals strenuously believe that auditors have no business being anywhere on, or even sniffing around, their turf. Or, for that matter, any place else outside their traditional, and very small, box.

> In addition to financial audits we now hear of environmental audits, value for money audits, management audits, quality audits, forensic audits, data audits, intellectual property audits, medical audits and many others besides.... If linkages between [these] practices are more than superficial, then some consistency should be evident between them over and above the sharing of a common terminology. (Power, 1996, 299)

Power's list is not exhaustive. Pickett and Vinten (1997, 53) added about ten more. IFAC published through its International Auditing Practices Committee (2000) a new framework for Assurance Services, starting at the historical financial data, extending through systems and processes, and moving on to behaviour.

IFAC presented descriptions and examples of subjects that could be classified under each of those categories in the framework. IFAC then defined two levels: assurance and review. Assurance is the top of the line, the A brand. Review is the second best thing. But this framework was developed by external auditors and operates completely from the perspective of financial audit. Therefore, it doesn't take into account the vast array of other kinds of audits that are currently on the menu.

Vaassen and Schelleman (2000, 102) criticized the IFAC classification. They wrote that by choosing arbitrary criteria and omitting clear borders between, say, financial and non-financial, and systems and processes, and behaviour, confusion is created. The whole matter should be investigated further. While their comments have merit, they do not mention that it may be very difficult, if not impossible, to make clear distinctions where they don't exist. To draw to here and no further lines in the sand between, say, financial, operational, EDP/IT and compliance audits.

Although classifications along those lines are also arbitrary, they would be better understood in practice. Thus in the context of this thesis the following definitions will be adhered to.

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. (NIVRA[8], 2003, 192)

This type of audit deals with financial data and statements in any form. The reporting framework is national laws or (inter)national accounting standards. "Fraud audits" are a subset of financial audits that focus on possible attempts of fudging and finagling the numbers.

Management control uses varying terminology. Some are fond of "management control auditing" (Paape, 1999). Others use "operational auditing", "the audit of the internal control system", or plain vanilla "internal control" (COSO, 1992, 1994). To prevent an even bigger Babel-like confusion and because it is the most frequently used term, we will use "operational audit" throughout this thesis.

Operational Audit is defined as:

> An audit of (parts of) the management control (or internal control) system of an organization to provide additional assurance whether this will enable the organizations to reach its objectives and, if needed, provide advice for improvement. (Paape, 1999, 303)

Since individual management teams design and adapt management control systems to suit their very specific needs, the framework for the audit will be provided by management, not the auditor. Therefore, frameworks will tend to be highly resistant to any attempt to generalize them for renewed use, at least for other companies. EDP or IT auditing is assumed to be part of the operational audit domain and will not be defined separately. This category includes many of the audits discussed above: performance, quality systems, ISO, and environmental.

Compliance Audit is defined as:

> An audit to assess whether the organization adheres to certain specific requirements of policy, procedures, standards, or laws and governmental regulations. (Ratliff et al, 1996, 763)

[8] Nederlands Instituut van Register Accountants.

This kind of audit uses both internal and external frameworks and is, therefore, less in-house specific.

There are limits to what should be audited and what is, in fact, auditable. Power (1996) is justified in his concerns. Whenever a major scandal occurs, there seems to be a knee-jerk urge to do something, and do it quickly. For example, legislate to improve transparency by means of increasing the level of auditing. Without wondering if there is an exact fit - or even an approximate match up - between "solution" and "problem".

Pentland (2000) adheres to Power's ideas. He also has his doubts about what should be audited, and who should be doing the auditing. The tail end of that sentence raises some interesting questions. While many professions make assessments and evaluations, that does not mean they are auditors. So what's the difference between an audit and an assessment? What are the boundaries of auditing?

Boundaries of auditing

When complexity and risks increase, an independent expert, an auditor is exactly what the doctor ordered. Increased "ungraspability" is an important contributing factor to the heightened recent attention being paid to auditing. Power (1994, 304-306) notices that auditing might offer a solution to estimate the value of organizations. But the flip side of that coin is that auditing does not contribute to the "opening up" of organizations. On the contrary, auditing assigns more value to verification and validation than to transparency of the organization. And in this context Power speaks of a new "obscurity" in society. While auditing may create new transparency within the organization - at least for its bosses, the managers - it may also be creating more obscurity for everyone else.

Flint (1988) sketches a number of developments clarifying this. Examples of such developments adding to the increasing complexity are the strong growth of capital markets, more complex and unwieldy organizations, and the development and growth of pension funds and investment agencies. Other factors include the accessibility of information and data. This involves not only geographical restrictions, but also legal, organizational, time, or cost factors. For example, do the auditing (verification) savings justify the efforts, expenses, and whatever ill will that might be stirred up? Is changing things and making them, say, .5% better, necessarily better than leaving them as they are and not rocking the boat?

Auditing can be seen as a normative image of what an audit ought to be. At a technical level, auditing can be seen as a variety of specific operations, procedures and practices. Pentland (2000, 309) states: "Clearly, if we are to understand what auditing is, and what it is becoming, we need to do some investigation." Power (1997) calls this the "deep epistemological obscurity" of auditing. Pentland makes a provocative statement: "If so, then it may be equally illuminating to compare auditors to movies or television critics." (2000, 311)

If Pentland (2000) had said this at a gathering of professional auditors, he would have had good reason to fear for his physical well-being. Nevertheless, it is not as whimsical as it sounds, and deserves to be at least pondered over. What distinguishes an auditor from a television critic? In what else besides his opinion does his credentials and professionalism reside and abide? There must be more to it than, "because I say so". Otherwise, as almost everyone can imagine, freedom of speech could, and would lead to an epistemological worst case scenario.

Has it to do with the social aspect of auditing? It's true that the more social function of the audit stems from a combination of distrust of unverified data and confidence in the auditor.

> In a richer and larger cultural life, however, existence rests on a thousand premises which the single individual cannot trace and verify to their roots at all, but must take on faith. Our modern life is based to a much larger extent than is usually realized upon the faith in the honesty of the other. Examples are our economy, which becomes more and more a credit economy, or our science, in which most scholars must use innumerable results of other scientists which they cannot examine. We base our gravest decisions on a complex system of conceptions, most of which presuppose the confidence that we will not be betrayed. Under modern conditions, the lie, therefore, becomes something much more devastating than it was earlier, something which questions the very foundations of our life.... modern life is a "credit economy" in a much broader than a strictly economic sense.[9]

As we have already said - without any claims for originality - knowledge is power. And the same is true of auditing, which strives toward certain types of knowledge. But, as with all power, it comes with risks and consequences. For example, if the auditor's message is not liked, his employers might reject the message and shoot the messenger.

An audit is, therefore, by definition *ex post*. To come to a professional and reliable judgment one should be able to use the underlying evidence. The audit product is a report, which contains an opinion about the object researched. The only way to come to an opinion is to base it on the acquired evidence in relation to the research object. Without evidence it is impossible to form an opinion. Based on the type of evidence, the quality and the persuasiveness of the opinions will vary. Evidence can exist in different forms (e.g., oral, written, and inferential). The weight of each type of evidence is determined in the context of the research. In this context the expert judgment of the auditor plays an important role. This should determine if in that particular situation a piece of evidence could be described as a "sufficient competent evidential matter".[10]

While helpful tips and rules of thumb on this subject are extensively discussed in professional books, the theoretical frameworks are in the same premodernist phase as audit definitions. If you think about that for more than a nanosecond, you will probably note that this is much more than coincidental. Silvoso (1972) referred to the issues of sufficiency of evidence and when observations are admissible as evidence. The latter is the case only if they meet the condition of inter-subjectivity. In science this would be dealt with through "repeatability". If observations can be repeated, especially by more than one person, producing the same result - more or less - that will increase credibility and it can be admitted as evidence. But, unfortunately, observations of business transaction are never repeatable.

> The most that we can hope for is this: S1 observes Y. Would S2 have observed Y, provided he had been in the place and time when S1 observed Y?' This is called repeatability. He then lists a number of factors contributing to errors in observation that forces one to question the usefulness of the concept of inter-subjectivity as well. (1972, 45).

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[9] Georg Simmel, "The Secret and the Secret Society"
[10] Mautz & Sharaf (1961), pp. 43-68

How very real those obstacles are is also acknowledged in many other sciences. Partington (2002, 86) stated, "Yet even in experimental research there may be no such thing as the completely detached observer". Positivists may claim that objectivity is something that can be achieved. Many others disagree, and vehemently. For those interested in beating their brains against these conundrums, see Johnson and Duberley (2000).

2.3 What constitutes an (internal) auditor?

Authority and professionalism

The word auditor originates from Latin and literally means listener. It was the task of the auditor to listen carefully and, based on his knowledge of the conditions, to evaluate if the farmers who had to account for their revenues did this in a manner that was consistent with both regulations and reality. (Most, 1969, 17)

Within the audit concept, authority is one of the most important starting points. Without authority little value will be attached to the opinion of the auditor - or anyone else, for that matter. But what is authority? Where does it comes from and what is it based on? And how does one obtain and retain it? Or, when things go horribly wrong, lose it?

Authority in the realm of auditors is intimately entwined with professionalism. But which comes first: authority or professionalism? Fasten your seat belts, because once again - and by no means accidentally - we find ourselves on the slippery slope of chicken and egg questions.

Some say that professionalism implies authority. This also implies that society should have confidence in the expertise and independence of any auditor: the basic elements of authority. Without these two core concepts, auditors cannot fulfill their social function. These elements will be addressed separately.

Burns, Greenspan and Hartwell (1994) researched professionalism in internal auditing. Their view is that prior to 1977 internal auditing did not qualify as a true profession, because it failed to set professional standards. This changed in 1978 by the release of the "Standards for the Professional Practice of Internal Auditing of IIA Inc". The events that led to a significant elevation of professionalism were the enactment of the US Foreign Corrupt Practices Act in 1977, passed on Friday, December 9, 1977 in response to the scandal of Lockheed's bribing schemes in order to induce foreign countries, including Germany, to buy up very difficult to fly Starfighter jets.

Expertise requires knowledge and professionalism that the auditor should acquire from education, on the job training, and experience. Thus legislators set requirements that must be met before people are qualified and entitled to perform audits. The knowledge that an auditor should possess is not limited to financial knowledge. To form a professional judgment one should have knowledge of different disciplines. This knowledge is important to place issues in the proper context and perspective. Expertise is not only a requirement for an auditor to form a judgment on a certain subject. It is also the stone that the concept of reliability is built on. Third parties will only accept the judgment if they believe that the auditor is knowledgeable of the business and also demonstrates this.

O'Connor (2004) would argue that this has to do with competence. Competence is the basic feature of any professional: primarily vested by education and training and demonstrated via licenses and "*education permanente*". A well known expert in psychology, Professor Wagenaar once said: "If we cannot solve a problem, we go for another problem that we think we can solve". This seems to be the case with defining professionalism, authority, expertise and competence - and, as we will see, objectivity and independence. If we cannot define the one properly, let us focus on the other and try to define that. Something along the lines of if two wrongs don't make a right, try three. It looks like an endless game of postponement.

Further, strict behavioural rules should apply to auditors. From the moment auditors started to become an independent profession, the most important professional ethical values were expertise, clearness in performance and expressions, trust, confidentiality, impartiality and independence. These are the core concepts of auditing ethics. Organizations such as the American Institute for Certified Public Accountants (AICPA) and The Netherlands' NIVRA tightly control and safeguard these behavioural rules, either in the form of standards for auditing, or in a professional code, and accompanying disciplinary powers.

According to Flint (1988, 64), the elementary characteristics of an auditor are "probity and strength of character". An auditor should approach an audit assignment without bias or any prejudice. This requires integrity and adherence to professional codes of conduct. Auditors should also not have personal involvement with the audit due to existing relations, financial or other interests, or interest regarding the outcome. One question is if these characteristics are the first thing that springs to mind when the public thinks "auditor".

Confidence is based on the belief in the presence of these characteristics. The auditor is an honorable man - he wouldn't lie - and, therefore, the fruits of his labor are worth more than the paper they are printed out on. In other words, an auditor's word is his bond, and reputation is key to both him and the profession as a whole. Society's trust in auditing is also dependent on the results of earlier audits, and to maintain that trust and the legitimacy to, the independent attitude of the auditor should appear from inviolable behavioural rules. An auditor who does not comply with the regulations is subject to the disciplinary law of the professional organization. As shown above from the Georg Simmel quote, faith and confidence have become increasingly important in modern society. Perhaps, in contrast with his assertion, this has always been so.

Independence and objectivity

Now let's look at the myriad of concepts used to make up for the characteristics of any auditor. Professionalism, authority, integrity, independence, probity and strength of character, trust, confidentiality, impartiality, objectivity, without prejudice, expertise, knowledge, and competence. All distinguished and lofty words that sound like they must mean a lot. But when push comes to shove, or even before, what exactly?

Let's try to nail down two of those highly debated and debatable terms: independence and objectivity. Independence, one of the main themes in the audit profession, both external and internal, has many aspects.[11] Arens and Loebbecke (1994) distinguish "independence in fact" and "independence in appearance".[12] This distinction occurs more often. Factual independence has no value, as audit stakeholders do not see the objectivity of that. Therefore, it is important that auditors clearly indicate the extent and validity of their findings. Kocks expands the concept with two other aspects, namely independence "in mind" and "in behaviour".[13] This subject was already touched on above. From that perspective, one would be inclined to regard this as more rhetoric than reality.

The authority of an audit and the degree of acceptance is partially based on an auditor's perceived, and actual, independence. In all cases where an audit is executed the audited party has accepted the underlying norms with regard to the reporting, duties, and other criteria. The audited persons have an interest in the research and are also in a position to influence results. The objective of the audit is "to secure accountability" (Flint, 1988, 29). It is important for credibility and objectivity that the audit stands completely apart from the person whose behaviour is being evaluated. If this wasn't the case, the audit could be seriously compromised.

The audited party agrees to be audited because he basically has no choice. Do it or else. But he will continue to do his utmost to control damage. That is, not reveal any more than he absolutely has to. At the same time, the auditor needs unrestricted access to all relevant sources of information. What information is relevant can be determined only *post facto*. That is, after it has been scrutinized. Otherwise, the auditor's judgment about the value of, say, an annual report, could be seriously impaired. Based on his research, a report is written presenting findings and conclusions. This report should be published without further consequences for the auditor. The importance of this postulate is such that it forms a separate subject within auditing theory.

Defining independence and objectivity is a difficult task. That wouldn't overly concern us if the audit profession didn't lean so heavily on these concepts. One could even say, without exaggeration, that it is founded on them.

Independence is a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals. However, these studies (*on independence of corporate boards in this case*) have to use rough proxies for independence: the simple absence of a job with the company, a close family connection or (perhaps some regular stream of income from the company apart from directors' fees and dividends are all that it take to qualify. (Langevoort, 2000, 3)

The chairman of the dissolved Independence Standards Board (ISB) – an initiative of the SEC and the AICPA - Allen, delivered the 1997 Seymour Jones Lecture in Accounting at New York University's Stern School of Business.

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[11] Which is quite remarkable since both operate in different spheres. One outside the company and, therefore, supposedly more independent than the in-house player.
[12] Arens and Loebbecke (1994), p. 79. See also Flint pp. 54-61.
[13] H.C. Kocks (1997), "General principles of auditing", incorporated in reader postdoctoral education RO at Erasmus University Rotterdam, p. 10.

> Our capital markets are the envy of the world and are an important component to the efficiency of our economy. The capital markets work on information, including financial statements audited by independent professionals. We believe that the attestation of a competent, independent auditor adds value. There is unanimous agreement that the *independent* judgment of expert auditors and the perception of that independence is a condition of the utility of the auditors' attestation. What does and should constitute independence in this context is not however always obvious.

Allen's contention is that independence and the lack thereof might in the end be related to the efficiency of pricing of securities in the market. In other words, independence has instrumental value. According to O'Connor (2004), the AICPA and SEC claim that independence has a value in and of itself.

O'Connor continues:

> But if regulators are not clear on what the real purpose and value of independence is, then it is no wonder that the regulations they promulgate appear fragmented and lack cohesiveness. (2004, 42)

It is Allen's claim that independence is a proxy (it has no intrinsic value) of objectivity and integrity. In that respect he differed from the SEC and the AICPA and might have come up with fresh views. However, according to O'Connor, the ISB was influenced by the views of AICPA SEC because it allowing a number of CPA's to join. Before discontinuing the organization on July 31, 2001, ISB produced a number of Discussion Memorandums. One of them dealt with auditor independence and came up with four personal attributes: competence, diligence, integrity, and objectivity.

Competence is the ability of an auditor to perform the technical audit itself. Diligence, the new addition, is the useful notion that considers whether a competent auditor actually uses it in any given audit. Integrity is the capacity of the auditor to resist temptations to perform and report the audit with intentionally less than scrupulous adherence to presented facts. Objectivity is the capacity of the auditor to perform and report the audit without intentional or unintentional biases.

Is this progress? O'Conner (2004) doubted it and concludes:

> "Independence" *per se* is unnecessary or irrelevant in these examples [doctors and lawyers] for two reasons. First, a client or patient is unlikely to hire a professional whom he believes to have a strong alliance with an individual or organization whose interests are adverse to his own. Second, in the traditional professional services environment where doctors are simply doctors, lawyers simply lawyers, and accountants simply accountants, the "reputational capital" of the professional is based on the public's belief that the professional acts with objectivity and integrity. Professionals who engage in reputation-depleting activities will likely find themselves with few clients over time, regardless of their "independence".… The solution [for auditors] is to institutionalize "objectivity" and "integrity" such that auditors who meet the criteria will generally act with objectivity and integrity even on behalf of the unknowable investing public. The result is "independence".

One might argue that this debate draws heavily on the notion of the external auditor. But the IIA Research Foundation (2001b) also produced a study on independence and objectivity. It notes that the focus of Standards and other literature regarding independence is mainly focused on "perceptions" of independence.

> Our analysis of the literature indicates that independence and objectivity are often treated synonymously and often with a lack of clarity. Standards have invariably focused on independence and have paid only scant attention, if any, to the concept of objectivity. Standards have also variously discussed "independence in appearance", "independence in fact", "independence of mind", and "mental attitude". Little effort has been spent on defining those concepts, explaining the difference between these concepts and that of objectivity or on how they relate to an effective audit. (2001b, 13)

The report continues that "objectivity" should be the primary focus of attention. The rest follows as a result from enhanced objectivity. Objectivity is defined as a state of mind and as freedom from bias, expressing or involving the use of facts without distortions by personal feelings or prejudice. The stand of the IIA Inc is that the organizational position is a determinant factor for independence, which in turn fosters objectivity. Already in 1972 (Silvoso, 1972) the Committee on Basic Auditing Concepts declared freedom from bias as the main concern of audit. Again, from the perspective of the external auditor. This report stated that "the condition of 'conflict of interest' is the most important single determinant of the need for the audit function" (1972, 31). The issue was drawn into the core concerns of auditing and audits.

What have we learned thus far? Independence seems to be a result rather than an instrument. If we focus on objectivity and integrity, independence will be the outcome. Okay. But does it bring us any closer to our goals? Probably not, because defining objectivity and integrity and putting it to work isn't any easier than independence itself. This much is obvious. While beating the drums of "independence" seems to be an essential part of the rhetorical rituals of the profession, it is essentially that. It might be best for internal auditors not to emphasize independence too much. Because if it is problematic for external auditors, it is doubly so for this sub-species. Internal auditors are by definition part of the organization and paid by management itself.

Organizational position

According to IIA Inc's Professional Standards (2001d), the organizational position is highly intertwined with independence and objectivity issues. In another report (2001b, 8), it takes the position that professionalism and objectivity make up for effective internal audit services. It is important to note that the IIA report points out that independence for internal auditors is more problematic than it is for the external auditors. The reasons for that are internal auditors are not only dependent on management, but also the increasing importance of internal audit activities conjoined with the growth in demand of IA consulting services leads to escalating concern and requires a response from the profession (2001b, 3).

Interestingly, the report continues, it is not appropriate to copy the SEC and AICPA approach by listing hundreds of pages of regulations to steer independence. Surely, that would add up to many more pages than there are for the external profession. The IIA tries to learn from the "negative experience of the external audit profession with this approach over the past 70 years" (2001b, 4).

The report focuses on the objectivity subject as a process that can be managed. In a footnote it is stated: "The concept of managing conflicts of interests is important since one can never be totally free of conflicts that may impair objectivity." (2001b, 16) In a way it is just a matter of downsizing the problem as much as possible.

Professionalism in its turn is defined as integrity, competence and the use of due care (or diligence). Integrity is defined by the IIA Inc as "an uncompromising adherence to a code of moral values and the avoidance of deception, expediency, artificiality, or shallowness of any kind" (2001b, 9). How on earth will this be measured – if at all - and against what standards?

Competence is easier to understand. "Competence means having the intelligence, education, and training to be able to add value through performance." (2001b, 9) Surely, competence is acquired via education, training, intelligence, and a system of licensing and *education permanente*. On top of this there might be supporting systems, such as quality reviews and the possibility of disciplining by other professionals.

Due care has to do with the way internal auditors carry out audits. While elaborating on due care, the IIA Inc suggests to include "perspective compatibility" (2001b, 10), referring to an individual's view or perception of a given situation. Auditors should be aware of the interests of the stakeholders to whom they owe a duty. This is an extremely important point. First, because this means that the internal auditor has to readjust his focus and understand who his "bosses" or "responsible parties" are, their interests, and how he should set about looking after them.

It is useful at this point to discuss the issue of the auditor's position within the organization. If there is more than one boss to serve, there surely will be different interests. Would it be fair to say to say that this needs to be part of his job description? Surely, that would make easier both his life and the ability to measure whether services were rendered as requested and demanded by his superiors. If there are differing, and even conflicting, interests, the implicit would become explicit by writing them down, and then they could be sorted out in terms of priorities. Otherwise, the poor auditor would be squeezed like a lemon. Or a stone. It would also demand making a case for make for why certain audits are required and who the auditor should report to. As long as the number of stakeholders is limited to one, these problems will not arise. But this is most certainly not the case. Interestingly, the IIA Inc study took stock and came up with the following 6 parties: management, employees, board of directors, audit committee, owners (shareholders), and the general public.

The study already acknowledged that, "Each of those parties will want, or at least will be perceived to want, different things from the audit, highlighting the importance of a consistent perspective across the audit team and function" (2001b, 10).

The IIA Inc (1994) agreed that the interests of constituents to whom an auditor owes a duty drive the auditor's obligations. But this does not necessarily require an explicit statement by a stakeholder. No. The auditor is often in a better position to understand what actions to take to act in the best interests of his constituents. The IIA Inc study calls this "perspective compatibility", between internal auditor, audit team, management, the board, and, if performing regulatory assurance services, the general public. That's interesting! Without even touching on the grand notion of "perspective compatibility" one most certainly could argue whether any internal auditor would be pleased to make the judgment calls that require balancing differing needs by differing constituents without prior written consent. Who will cut the Gordian knot in the cases of conflicting interest, which, as we have already said, are inevitable? The auditor himself? Any auditor who has been around will know by experience the difficulty, if not the impossibility of this task.

As shown above, independence and objectivity are relative in nature. If we – like Allen of the ISB - would define independence as a result of objectivity and integrity, then the issue would be that we need to foster those attributes and that an increased independence will result from that. This would imply that the organizational position in itself would need to be such that objectivity and integrity would be enhanced. Whether integrity will be affected by a different organizational position might be difficult to envision. But objectivity might be enhanced if IA's organizational position is as high as possible.

Since IA and the Chief Audit Executive are members of the organization, they are subject to and report to the Management Board. And sometimes even further down the pecking order: to lower managerial levels. In Agency Theory terms, the principal resides within the company, thereby creating, maintaining, and possibly even exacerbating dependence. Not independence. He who pays the piper calls the tune. The situation is not much different for an outsourced internal audit services provider. Again, management pays the bill. The question then is whether independence will be enhanced if the organizational position is altered. If so, the question becomes what will be the best level to report to.

The IIA Inc, of course, stresses the need to have an in-house IA. But what if it is outsourced? Would that foster objectivity and integrity? According to O'Connor (2004), no. And, according to the IIA Inc study (1997a), this is not an argument in favour of outsourcing either. From an Agency Theory perspective, this is rather strange. After all, the outsourced IA members will not be part of the organization and, therefore, less subject to some of the abovementioned pressures. In their study, IIA Inc acknowledges that outsourcing may be a solution to the problem of impaired objectivity (p. 35). But, "Such decisions, however, will require additional financial resources and may lead to unease among internal audit staff". One might conclude that impaired objectivity is not a problem because solving it involves incurring extra costs?!

2.4 Role

This section deals with the role and rationale of IA and whether it should be in-sourced or outsourced (make or buy).

In 1957, MacPherson, Sinnott and Stokvis placed the internal audit profession in the realm of the industrial revolution and subsequent growth of scale and complexity of organizations, thereby explaining the rationale for internal audit from the perspective of Agency Theory. From what the speakers said the answer to the questions, "Why does IA exist?" and "Why do some companies have them and others don't?" was simple: management needed them. The simple truth must be that there is no other answer than that. Since internal auditing is not mandatory, a direct need must be met. That in itself doesn't end the dispute. Take a look at the following.

In an IIA Inc study (1997a) pertaining to outsourcing the following was noted: "we need to think about what is truly 'unique' about the internal auditing function. When we asked internal auditors to define what was 'unique internal auditing', no one thing stood out. The closest thing to being unique is the internal control orientation of existing external internal auditing departments." (1997a, page xii) If the internal audit community isn't able to formulate what is unique about them, then there is really a need to worry! The same study also concluded that internal auditing is not homogeneous (1997, 125). Therefore, we shouldn't hold our breaths waiting for an
one size fits all answer to what it is and isn't. The study also concluded that if a function is not unique, it will be more susceptible to outsourcing.

If management has a need, then the option is to either create one internally or hire them in the market: make or buy. There is a market where these services can be obtained. The best suited candidates would be the public accountancy or specialized firms. There has always been some kind of animosity between internal audit practitioners and external parties providing internal audit services. This should come as no surprise, since out- or in-sourcing will impact the job market for internal auditors and the services of internal audit from an expert perspective might be rendered by an outside provider. On the other hand, internal auditors can make their career within the professional auditing firms as well.

The Research Foundation of the IIA ordered a study (1997a) on the outsourcing issue. Although the study was quite lengthy – almost 150 pages – the lack of substantiating data was staggering. The study concluded: "There is not a large enough database available to reach any final conclusions about total outsourcing, but it is safe to say that there have been many successful partial and full outsourcing arrangements." From a scientific perspective that is a disappointing conclusion.

The IIA Inc. Standards (2001d) do not deal in any shape or form with the make or buy issue. In 1998 it published "A perspective on Outsourcing of the Internal Auditing Function", which, since it never achieved the status of a "standard", was deemed a professional practice pamphlet. According to this pamphlet, it is best to keep IA in house. What else might one expect from the IIA Inc?

A study of Widener and Selto (1999), using a Transaction Cost Economics perspective, is useful for studying the outsourcing issue. There are two main conclusions to be learned from it. One, the higher the Asset Specificity the less outsourcing will be used. This is consistent with the findings of Williamson (1996): Asset Specificity is the most determining factor in the question of make or buy. Two, the more often internal audit is used, the more often the function is positioned internally. For a more detailed discussion we refer to Chapter 4.

The issue is whether buying internal audit services would be valued by outsiders due to a perceived increase of "independence" of the outside provider compared with an internal provider. An interesting experiment was done by Lowe, Geiger and Pany (1999). One hundred and seventy-seven loan officers were supplied with a realistic loan application for a medium-sized retail grocery company and asked to evaluate auditor independence, assess the reliability of financial statements and decide whether they should, or should not, grant the loan. The participants were given the same information, except for the description of IA, which varied as follows:

1. Not outsourced, done in-house.
2. Outsourced to an external auditor other than the one that performed the company's external audits.
3. Outsourced to their own external auditor, which performed management functions.
4. Outsourced to their own external auditor; same personnel used for the internal and external audits.
5. Outsourced to their own external auditor; different personnel used for the internal and external audits.

When number 3 came to the fore independence and reliability ratings dropped, and loan officers were least likely to grant loans. By contrast, with number 5 - same external audit company, different personnel - independence and reliability ratings were significantly higher and loan approvals were the highest. These results were consistent with the AICPA's position of allowing external auditors to perform outsourced internal audit activities for clients as long as they did not perform management functions in connection with the internal audit. However, the results also show that perceived auditor independence and financial statement reliability could be enhanced by requiring CPA firms that perform internal audit services for clients to use different personnel for each type of engagement. The study was done from the perspective of the external auditor providing internal audit services, and not at the perceived differences in independence between internal and external auditors providing the same services *per se*. The data, however, does provide support that there is no real gain in the perceived level of independence either by in- or outsourcing IA. Further, the current status of corporate governance affairs, as described in Chapter 4, prohibits certain outsourcing to the current external auditor, even if they do they use different personnel for each type of engagement.

In the financial services industry (full) outsourcing is prohibited if it is economically viable to afford one. Recently, the Sarbanes-Oxley Act law and the subsequent guidelines from the SEC and the Public Company Accounting Oversight Board (PCAOB) prohibit certain internal audit services to be delivered by the external auditor signing off on the annual report. Besides that, there are no Corporate Governance regulations and recommendations that provide clear guidelines regarding the make or buy issue. Professional bodies like IIA Inc and AICPA only provide guidelines about how to cooperate. We will come back to that later in this chapter.

While the outsourcing issue has sparked much concern and discussion among internal auditors themselves, there doesn't seem to be any evidence indicating that it is happening on a large-scale. True, there are cases of it here and there. But this seems to be limited and more an example of co-sourcing, whereby the external provider is compensating for a shortage in staff or skills on the part of the in-house IA. For the moment at least, I conclude that it is "Much ado about nothing". Competition in itself is prima facie healthy, not just from the perspective of management, but also from the profession, because stretches professionals to the limits of their competence. In addition to the data already provided here and in Chapter 4, the survey (see Chapter 6) will provide some more data to back this up.

Concluding this section, one might say that despite the fact that there are no laws making IA mandatory (with the exceptions for the financial services industry), developments show an increasing interest. Surely, management must have an intrinsic motive to have IA. Much of the why of that will be discussed in Chapter 4. But perhaps there are less obvious reasons that also might explain this need. In the Chapter 5 case studies and Chapter 6 survey some answers will become apparent.

2.5 Position

This section will shed light on the issues of the organizational position, size, staffing, and how to control IA.

Organizational position

Let's begin with position and corporate governance: two very important factors when it comes to independence. There are a number of IIA Inc. Standards (2001d) dealing with independence and objectivity. No. 1100 is the generic one (independence and objectivity), further detailed in 1110 (organizational independence), 1120 (individual independence), 1130 (impairments to independence or objectivity), and no less than five different Practice Advisories. Although independence is very much emphasized in the Standards and many publications, Hawkes and Adams (1995) found that customers feel that internal auditing is enhanced when auditors and their clients establish close relationships based on a cooperative and participative approach as opposed to an independent and prescriptive appraisal function. Thus despite the views of the profession in general, there is some disagreement from outside.

Standard 1110, which deals with organizational independence, states: "The chief internal auditor should report to a level within the organization that allows the internal audit activity to fulfil its responsibilities".

The relevant Practice Advisories, 1100 and 1110, continue:

> Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of engagements. It is achieved through organizational status and objectivity.

And:

1. Internal auditors should have the support of senior management and the board of directors (BOD) so they can obtain the cooperation of engagement clients and perform their work free from interference.
2. The Chief Audit Executive should be responsible to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations.
3. Ideally, the Chief Audit Executive should report functionally to the Audit Committee, board of directors, or other appropriate governing authority, and administratively to the Chief Executive Officer (CEO).
4. The Chief Audit Executive should have direct communication with the BOD, Audit Committee, or other appropriate governing authority. Regular communication with the BOD helps assure independence and provides a means for it and the Chief Audit Executive to keep each other informed about matters of mutual interest.
5. Direct communication occurs when the Chief Audit Executive regularly attends and participates in meetings of the BOD, Audit Committee, or other appropriate governing authority which relate to its oversight responsibilities for auditing, financial reporting, organizational governance, and control. The Chief Audit Executive's attendance and participation at these meetings provides an opportunity to exchange information concerning the plans and activities of IA activity. The Chief Audit Executive should meet privately with the BOD, Audit Committee, or other appropriate governing authority at least once a year.
6. Independence is enhanced when the BOD concurs in the appointment and/or removal of the Chief Audit Executive.

Quite frankly, the way independence and objectivity are used interchangeably by the Standards, may cause confusion. As demonstrated above, independence for IA is an oxymoron. The same goes for objectivity. As already described - not only above, but also in Chapter 1 - the scientific debate is around two extremes: objectivity and subjectivity. This research is based on the premises of neo-positivism, allowing for "a more subjective approach than any hard-line positivist would dream of"'. Objectivity as in presuming one can take a look at facts without any bias from dominant paradigms and personal feelings is very hard to do, if at all possible (Johnson and Duberley, 2000 and Partington, 2002). Independent as in subject to no one else and not being ruled by anyone or anything is in this respect definitely not the case. However you slice it, the IA reports to some principal, is his agent and, therefore, not independent.

The issue then remains, what is the best level to report to in order to foster the maximum amount of objectivity independence? From an Agency Theory perspective, the question is, what is the most appropriate principal for IA? An apparently feasible option is to go completely outside the organization. That is, outsource the IA. But then the Chief Audit Executive would no longer be seen as "one of us", which according to Williamson (1975, 1996) is one of IA's main advantages over External Auditor (see our discussion of Transaction Cost Economics in Chapter 3). He reasons that this insider status enhances the flow of information, and that would be eliminated if the Chief Audit Executive were an outsider.

This study has been conducted from the perspective of a two-tier Corporate Governance system, since this is the dominant one in The Netherlands. The IA could either report to the Management Board or to the Supervisory Board/Audit Committee. Both options are still within the organization and, therefore, the IA would not be considered an outsider. This would lead to the following scheme:

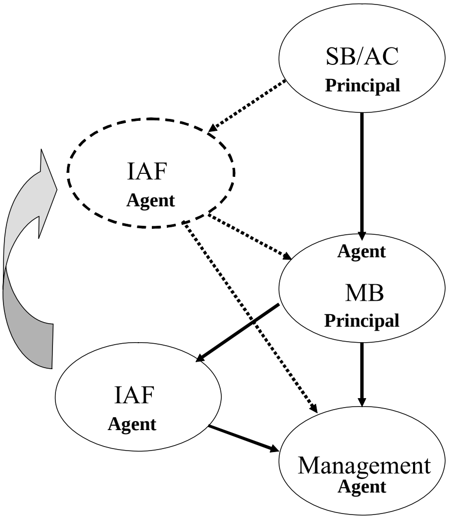

Figure 4: Possible Re-shift of the IAF: Increasing independence?

The outcome would be that, in Agency Theory terms, the relationship between the Management Board and IA changes from a principal-agent to an agent-agent one. The question would then be whether the Management Board will cease to regard IA as its instrument. And if so, what might that mean? Are they going to create a new one, solely serving them? Surely, the most logical reaction would be that IA is now in the hands of the Supervisory Board and out of the direct control of the Management Board. On the one hand, that would inherently foster independence. On the other, that might stir up a fair amount of alienation within the organization, and not only within the Management Board. The Williamson argument that they are "one of us" might also be affected as well. In the case studies this issue has been addressed and this will be discussed in Chapter 5, with some surprising results.

While the IIA Inc. Standards (2001d) do not provide a clear statement about whether or not IA should report to the highest level of an organization, the Practice Advisories do. The ambiguous distinction between "functional" and "administrative" reporting lines is further detailed in yet another PA (1110-2), where the following explanation is given:

> The functional reporting line for the internal audit function is the ultimate source of its independence and authority. As such, The IIA recommends that the Chief Audit Executive report functionally to the Audit Committee, Board of Directors, or other appropriate governing authority. Administrative Reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit function.

The IIA Inc seems to be of two minds. Standard setters seem to acknowledge via the Practice Advisories that the Audit Committee would be the most suitable candidate. But the Standards themselves are less outspoken and for reasons one can only guess. Maybe their perspective is influenced by what would be acceptable to members of the Management Board. And who would blame them?

Now let's take a look at some data pertaining to the positioning of IA within the organization. Using a 14-page survey that was sent to 750 CIA's in US associates, The Conference Board studied reporting lines in mid 1988 (1990). The response rate was 51%, and covered 375 surveys.

Table 2-1: Reporting lines of the Chief Audit Executive (surveys Conference Board)

Reporting lines (in%)	1963	1978	1988
CFO	7	34	48
CEO	2	6	17
Audit Committee	0	5	10
Controller	54	30	15
others	37	25	10

The development is clear. There is an undeniable shift towards higher ranked officers and also the Audit Committee is increasingly reported to. There are other surveys (IIA, 2001c, p 88) showing that the trend continued.

Table 2-2: Reporting lines of the Chief Audit Executives (survey IIA Inc)

Reporting lines (in %)	IIA Inc 2001[14]
CFO	59
CEO	9
Audit Committee	32
Controller	12
others	11

The trend may even have gained in pace. According to Gray (2004), due to the Sarbanes-Oxley Act internal auditors might be on the verge of being reporting to the Audit Committee. "In terms of status, they are now reporting directly to the audit committee and play a greater role in the audit committee's meeting agenda." (2004, xvi) But it comes at a cost. That is, the image of IA is shifting back toward the dreaded "company police officers" - hatchet men - (2004, xxi) instead of the desired (by the profession that is) image of partners or consultants.

[14] The numbers add up to well above 100% because multiple answers were possible.

As will be shown in Chapter 3, many IAF's functionally report to the CEO and administratively to the CFO or the like. At the end of the day, the administrative report will most likely be the one who "signs the pay check" and will be leading in appraising the Chief Audit Executive and the IA. From the agency perspective, nothing really changes. Both CEO and CFO are members of the principal body for IA. Hughes (2004) has some strong feelings on this issue as well.

> It is time that the audit committees quit undermining the internal auditors by having them report to the CEO or CFO, the most likely originators of fraudulent practices. The internal auditor should report both functionally and administratively to the audit committee.

That these issues have been bobbing around for a long time can be seen by comparing statements from nearly 50 years ago and now. In 1957 Walker (1957, 9) wrote that IA could report to the controller, treasurer, or "any officer of sufficient rank as will assure adequate consideration and action on the findings and recommendations". But, according to him, it was neither necessary nor practical to report to the Management Board. He wrote, "in our opinion, it is not practical in most cases because we believe internal auditing can be most effective as a tool in the hands of active management" (1957, 9). Surely, almost 50 years ago it was a different era, allowing for a different set-up. As will be shown below, the current era would sharply disagree with what was then acceptable.

In Chapter 4 I will come back to this subject. For the moment, let us conclude that Tabaksblat (2003, 31) is ambiguous about who should be responsible for the care and feeding of IA, and who it should ultimately be responsible to. Yes, it should operate under the Management Board. But the Audit Committee also has some responsibility for IA.

Irish (1957), a representative of the Institute of Chartered Accountants in Australia, states that the internal auditor must be able to act without fear or favour and he should not be pilloried if he speaks unpalatable truths. "Superficially at least, this would seem to demand [that] he be given some element of independence." (1957, 17) A sentence like that nowadays would make many internal auditors shiver with horror. Words like "superficially" and "some element of independence" show a disdain not worth repeating. The tenor that one catches every now and then during drinks at the bar is the old dispute between internal and external auditors about who is best suited to serve the needs of management. And sometimes one notices glimpses of that in Corporate Governance codes like Tabaksblat.[15]

Irish acknowledges of course that there is a principal-agent relationship that hampers independence. He goes on to stress the need to clarify the role and objectives of the IAF and the need for every internal auditor to be independent in mind. This also seems to be a Pavlovian response. It seems that everyone is aware that independence is not going to be solved via positioning the IAF somewhere in the organization under the jurisdiction of the Management Board. The *deus ex machina* is the independence in mind, relying heavily on the character of the professional, like the "probity of character" good luck mantra uttered by Flint.

[15] One of the best practices reads as follows: "The external auditor and the audit committee shall be involved in drawing up the work schedule of the internal auditor. They shall also take cognizance of the findings of the internal auditor'." This shows that the internal auditor is what the external auditor would like him to be.

MacPherson (1957, 21) is exemplary in this respect. He stated, correctly, that independence is relative and not absolute, and referred to mental attitude as an essential element for any internal auditor. Stokvis (1957, 49) swam against the current at the 1957 conference and showed that he was ahead of the curve by proposing that "it is essential that the internal auditor should receive his instructions from top-management alone". His views are common ground today and have been elaborated in many ways in the IIA Standards.

All to no avail to solve the independence issue, I would argue. From an Agency Theory perspective, the best solution to the problem is to make the Supervisory Board/Audit Committee the principal of IA. The most important question resulting from that solution is whether there will be adverse effects that would lead the organization to come up with a second best solution. In the one-tier environment and the applicable corporate governance codes this is already forthcoming and envisioned. Whether Management Boards or Supervisory Board/Audit Committees like it or not, there is no other option than making IAF report to - and subject to - the Audit Committee. In a two-tier environment this might lead to more cut backs.

As became clear in the Tabaksblat code and the case studies, Management Boards do not like the idea at all. Supervisory Board/Audit Committee's are also reluctant to embrace this idea. As are Chief Audit Executive's. But the last mentioned are more in favour of this position because it will enhance their independence. However, they acknowledge that this will come at a cost and will not necessarily make life easier. The alienation of the rest of the organization – no longer to be seen as one of us – and the envisioned difficulties in opening up of interviewees and accessing information are certainly aspects to ponder. In organizations where corporate governance and culture are very well developed, no real barriers might be encountered. But for those that are lagging behind in that respect, Chief Audit Executives will be facing more severe cut backs.

There seems to be at least one differing view with regard to IA supporting the Audit Committee. Nagy and Cenker (2002) questioned 11 Chief Audit Executives and discovered that most of them said their role in assisting the Audit Committee of overseeing financial reporting had not changed in the last few years. And none of them anticipated that it would change in the near future. But this was in 2002, just prior to the Sarbanes-Oxley Act coming into effect. All that would change shortly thereafter.

Tabaksblat came up with provisions that require the Audit Committee to stay in contact with IA. Biewinga, Bossert, and Dassen (2003) regretted that Tabaksblat did not allow for a direct communication line between Audit Committee and IA. In their view, the Audit Committee needs independent information pertaining to the risk and control systems of the organization and IA would be best suited to be their supplier. I couldn't agree more. There is other research providing supporting data for a closer relationship between the Audit Committee and IA. Goodwin (2003) studied the relationship between Audit Committee and IA. Her conclusions are also worth mentioning.

> The most important finding of the study is that the independence of the audit committee and the level of accounting experience amongst committee members have a complementary impact on audit committee relations with internal audit. While independence is associated with a number of issues of process, it is the proportion of committee members with an accounting or finance background that is associated with the extent of the review of internal audit work.… It would appear that independence alone is not sufficient, and the extent of accounting expertise on the committee will help ensure that the audit committee makes appropriate use of the work of internal audit as recommended by the IIA. (2003, 274)

According to Goodwin, adequate expertise on the part of the Audit Committee is a necessary condition to maximize the positive impacts of IA. I am in total agreement with this standpoint.

Considering what happened later - after spectacular corporate failures like Enron, WorldCom, Ahold, and Parmalat - the Institute of Chartered Accountants of Scotland (ICAS) seemed to have been in possession of a crystal ball in 1993.

> In our opinion the corporate governance framework within which external auditors operate is deficient. We believe it is reasonable for the public to expect that the external auditors are independent of the directors of companies being audited. Within the present corporate governance framework it is not clear that this is the case. (1993, 29)

And with regard to internal audit their opinion is equally noteworthy. The Chief Audit Executive "should report to a Financial Reporting and Audit Committee (FRAC) made up entirely of non-executive directors. The FRAC should approve the appointment, and the termination of the employment of the Chief Audit Executive. The Chief Audit Executive should be free to communicate with the external assessors at any time" (1993, 32). ICAS continued: "We believe that companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfil its responsibilities." (1993, 35-36)

According to the ICAS, the FRAC should run interference between two sets of needs. One, those of the IA for independence and authority. Two, those of the external auditor to supervise and control IA activities. The Chief Audit Executive and the external auditor should attend all meetings of the FRAC. It is tempting to say that the developments discussed in Chapter 4, are just that what the ICAS paper already pronounced as desirable, although many at that time probably would have considered it "a bridge too far".

The IIA The Netherlands (1999) did a survey of Chief Audit Executives, and 58% of them agreed that the Supervisory Board should appoint the Chief Audit Executive. In a study by Paape, Scheffe and Snoep (2003) among 332 Chief Audit Executives of top-listed companies in the EU, it was shown that two thirds had an Audit Committee. But due to different regulations on the issue, the per country numbers went up and down like a yo yo. For example, in the UK - where Audit Committee's are required - 100% of the respondents had them. In Austria and Portugal – where they were not – the percentages dropped to zero.

When questioned who should appoint the Chief Audit Executive, 59% agreed it should be the Audit Committee. It seems Chief Audit Executive's in the EU like the idea of being appointed by the Supervisory Board/Audit Committee. Not surprisingly, because if they were to be appointed by the Audit Committee this would not only enhance their independence, but also their stature. Although the idea of being appointed by the Supervisory Board/Audit Committee might be appealing to the majority of the Chief Audit Executive's, there are some concomitant issues. I've already discussed the ambiguity in the corporate governance regulations with regard to the reporting issue. The reconfiguration, whereby the Supervisory Board/Audit Committee becomes the principal of IA, raises some interesting questions.
One of them is how to live up to the needs and expectations of both Supervisory Board/Audit Committee and the Management Board at the same time? Will it be possible to become a trusted party, providing assurance to both the Supervisory Board/Audit Committee and the Management Board? Reporting both might lead to the dilemma of serving two masters.

Van den Berghe and Baelden (2003) described this dilemma as follows:

> To whom should the internal audit (functionally) report? There are two possible ways of doing this. Either the internal audit is fully responsible to the audit committee, or the internal audit reports to the audit committee while being responsible to management. Conceptually, the first case seems more appropriate in order to align the (personal) interests of the internal audit with the audit committee's mission. But from a practical point of view, this approach is difficult to implement, as it is unclear how the audit committee should deal with the corresponding labor and management issues. Therefore, an approach where the internal audit functionally reports to management, but is ultimately accountable to the audit committee, is likely the best practical solution. This accountability could be affirmed in an internal audit charter. It is then the task of the audit committee to foster a culture of open disclosure and to make sure the internal audit unit can perform its tasks without any possible influence or pressure from management. (2003, 305)

While this is in line with my idea to make the Supervisory Board/Audit Committee responsible for IA activities, it is still as fatally ambiguous as many of the Corporate Governance reports. Management Board's do not like the idea of an internal function reporting directly to their supervisors. And one doesn't have to be a rocket scientist to understand why. Certain IA findings may be sensitive and Management Board's would not like to have them reported on without being on hand to address them. Since auditors are required to listen to all sides and discuss findings with auditees before reporting, this is a highly unlikely scenario. However, even after such preliminary discussions, IA findings could be reported, and they might have a potentially negative impact on the evaluation of the Management Board.

In those circumstances one could say, "so much the worse for the Management Board", because the Supervisory Board/Audit Committee definitely requires those findings in its task of supervising all aspects of the organization. If at the same time the Management Board is still responsible for appraising the Chief Audit Executive and IA this would almost definitely have severe repercussion. Therefore, it doesn't make sense to disconnect appointing the Chief Audit Executive and being reported to from appraising, supervising and directing him. That would be a waffling compromise that does nothing in practice to enhance Chief Audit Executive/IA independence. Once that is settled, let us deal with the practicalities in a pragmatic way. In the eyes of Hernando de Soto, a Peruvian economist: "massive informality appears when governments cannot make the law coincide with the way people live and work".

Koster (2003), a board member of *Autoriteit Financiële Markten* (AFM) – the Dutch equivalent of the US' SEC and the UK's Financial Services Authority (FSA) – follows the same track of reasoning and goes one astonishing step further. He recommends that IA should not only report to the Supervisory Board/Audit Committee and have its Chief Audit Executive appointed by them (2003, 121), but it should also cooperate with the AFM. That would require a functional line between IA and an outside supervisor and regulator. Now this is a provocative statement!
This may take some getting used to for some, but it isn't as far-fetched as it seems. These days, many in the alphabet soup of supervisors – the SEC, FSA and DNB – already have the authority to liaise and review IA's work. For some, the cure might be worse than the disease. For while it will undoubtedly foster IA independence from management, IA might wind up serving three masters. What's more, such an outside link would most likely alienate IA from the rest of the organization. Again, you don't need to be a Nobel Prize winner to start fantasizing about some of the negative blowback from that situation (discussed in more detail by Williamson in Chapter 3).

Koster, representing the AFM, is seeking to get as much information on what is going on inside any company. Supervisors like the AFM, suffer from information asymmetry, far more than the Management Board and the Supervisory Board. Thus he is inclined to dream up a fiscal Patriot Act to be able to execute his supervisory responsibilities. Although his problems are real, his solutions are not. Regulatory bodies like the AFM should have their own apparatus to investigate whatever they need to investigated. Making IA a player on their team would be the worst of all possible worlds for those on the inside trying to get along and do their jobs. Further, it would encourage police state powers and would not be in sync with what we consider an open society and free market.

I would like to conclude this section by quoting Jules Muis, previously acting Director-General of Internal Audit at the European Commission of the European Union in Brussels, on the independence issue.

> Having returned to the internal audit profession, right at the top, with a perfect Charter protecting my independence, and at almost 60 years old, seasoned, I do think that independence in practice is and will remain a huge problem, the Achilles heel, for internal auditors, and that we do not speak enough about it. If stepping up to the plate on that confessional score helps the internal audit profession, this is the time to throw me a ball. (2003, 61-62)

As shown, the independence of the IAF is according to the IIA fostered by its organizational position. The bottom line is that we are just beginning to scratch the surface of how crucial independence and objectivity are. Anything approaching an answer is still a long way off. But one thing is clear. As IA becomes more independent of the Management Board and more reliant on the Supervisory Board/Audit Committee, it might wind up more often in that sticky, tricky space that the Dutch describe as "between the dock and the ship", and the Americans as "between a rock and a hard place". IA might wind up having to serve two masters or, if Koster has his way, three.

Size

While a number of surveys were available to research the IA size issue, they had some major limitations. For example, there were such differences in the questions asked, ranges and scales used, countries, sample sizes and respondents used that comparison is difficult if not impossible.

The Conference Board study (1990) presented the following data regarding staffing levels.

Table 2-3: Staffing levels of Internal Audit by Company size

Internal Audit Staff by Company Size (n=362)					
Staff size	**1 to 10**	**11 to 20**	**21 to 50**	**51 to 100**	**101+**
Company size					
$ 25 - 499 million	95	3	0	2	0
500 - 999 million	82	16	2	0	0
1 - 1.9 billion	41	45	12	2	0
2 - 2.9 billion	10	31	59	0	0
3 - 4.9 billion	19	35	41	4	2
5 billion +	7	8	38	26	21
total companies	145	72	89	32	24
total percentage	40%	20%	25%	9%	6%

Table 2-4: Staffing levels of Internal Audit by Industry

Internal Audit Staff by Industry Group (n=364)					
Staff size	**1 to 10**	**11 to 20**	**21 to 50**	**51 to 100**	**101+**
Industry Group					
Manufacturing	46	21	20	8	5
Financial	17	16	33	14	20
Utility	40	27	25	8	0
Transportation	25	25	50	0	0
Retail	57	0	29	0	14
Other Services	27	55	18	0	0
Diversified	50	6	31	13	0
total companies	144	75	89	32	24
total percentage	39%	21%	24%	9%	7%

A Basel Committee (2002b) survey showed that in the EU banking sector an average of 1% of the workforce is in IA (71 respondents from 13 countries).

A number of others surveys, conducted by IIA The Netherlands (1999, n=30; 2002, n=53) arrived at the following results.

Table 2-5: Staffing levels of Internal Audit in the Netherlands

number	IIA 1998 N =32	IIA 2002 N = 53
less than 11	43%	37%
11 to 50	34%	35%
51 +	23%	28%

The Conference Board study (1990) also surveyed the budget for IA.

Table 2-6: Budget for Internal Audit by Company size and Industry

Internal Audit Budget by Company Size (n=331)							
Budget	**under**	**400k**	**800k**	**1200k**	**1800k**	**2500k**	**5000k+**
Company size	**$400k**	**799k**	**1199k**	**1799k**	**2499k**	**4999k**	
$ 25 - 499 million	84	14	2	0	0	0	0
500 - 999 million	57	36	7	0	0	0	0
1 - 1.9 billion	7	42	26	15	8	0	2
2 - 2.9 billion	0	4	30	30	26	10	0
3 - 4.9 billion	4	10	14	28	26	14	4
5 billion +	1	2	3	6	13	28	47

Internal Audit Budget by Industry (n=347)							
Budget	**under**	**400k**	**800k**	**1200k**	**1800k**	**2500k**	**5000k+**
Industry	**$400k**	**799k**	**1199k**	**1799k**	**2499k**	**4999k**	
Manufacturing	24	20	11	11	10	10	15
Financial	10	9	10	13	13	20	26
Utility	27	21	17	8	13	6	8
Transportation	14	14	14	29	14	14	0
Retail	14	43	0	0	0	29	14
Other Services	27	18	27	9	9	9	0
Diversified	27	7	0	20	20	7	20
Total companies	74	61	40	39	39	40	54
Total percentage	21%	18%	12%	11%	11%	12%	16%

The data shows that:

- ❖ The Financial industry has the highest staff levels and the largest budgets.
- ❖ The larger the company the larger the staff size.

A NIVRA survey (1993) came up with the following data.

Table 2-7: Size of the IAF in the Netherlands

Size of the IAF in The Netherlands (n=42)				
Industry	number of companies	number of staff	number of IA staff	ratio IA/total staff
Retail	1	32,800	5	1 : 7,160
Manufacturing	14	461,300	448	1 : 1,030
Services	8	89,000	177	1 : 503
Banking	9	146,000	720	1 : 203
Insurance	8	38,500	196	1 : 196

Although the number of respondents is low, the data provides support for the conclusion that financial institutions have by far the largest number of auditors.

The recent results from an IIA Inc study, performed by Gray (2004), indicate that due to the Sarbanes-Oxley Act, as staff numbers tend to go up, so do budgets, and more financial skills are required.

A few conclusions can be drawn. The financial services sector has the largest IA's and the size of IA increases as the size of the company does, be it by staff numbers or revenue. About 40% of organizations have an IA of less than 10. About 35-40% has a staff between 11 and 50, and about 20-25% have a staff over 50.

Control

There are many issues relevant for controlling IA. For example, quality reviews, leadership, and training programs. But for the purposes of this study we will be dealing with three sub-questions. One, how should the Chief Audit Executive be appraised? Two, how should he be rewarded? Three, who should be doing the appraising and rewarding? These questions tie in very well with the issues addressed above. This section will show that very limited literature spends any kind of quality time on how these questions can be best answered.

Nothing noteworthy was said about how IA should be controlled in the 1957 Seventh International Congress of Accountants, the mid 1988 survey of The Conference Board (1990), or the 1991 jubilee issue of *Internal Auditor* (IIA Inc.). While Sinnott (1957) only touched on the issue, he had some extremely interesting things to say. One, "the internal auditor should not to be judged by the number of mistakes uncovered" (1957, 34). But this just so happens to counter the image many auditors try desperately to get away from and that is the image of being a policeman and a bringer of misfortune and bad news. In recent decades, the added value drum was beaten hard and often, and that did not line up with the image stressed by focusing on mistakes and errors.

Two, he advocated determining the extent to which management accepted IA and followed its recommendations, because this "denotes confidence in audit activities". The problem is of course that the output of IA is not easily captured in performance metrics and, therefore, is difficult to measure. But that is no reason to leave the issue unresolved.

The first area is the "how" question. The IIA Inc (2003b, 203) notes that: "IAF's utilize a variety of compensation systems, including traditional salary based systems, pay for skill, and pay for performance incentives. Unlike external auditors, internal auditors may even participate in company stock-based incentives." Nash and Flesher (1997) present some ideas on this matter. They argue that the shift towards operational audit may create the possibility of paying incentive compensation to internal auditors, because they are less involved in pure financial audits and limit the possibilities of "overlooking" income-enhancing errors.

Which performance measures could be listed? Some examples are: number of errors found; realization of planned audits; number of audits; number of audits on request beyond the plan; client satisfaction levels; cost saving ideas; income increasing ideas;
cost containment for IA; cost containment for External Auditor; results of external reviews; results of quality reviews; staff development; and absence of unpleasant surprises.

Obviously, many of those measures are not directly linked to the effort and efficiency level of IA. Those that are may not always be telling the right story. For instance, the number of errors found may inspire IA to focus on finding errors wherever they can, even though it might not be looking in the areas with the most risk. Following the path of least resistance might be the result. Client satisfaction levels may induce IA to push the envelope of pleasing their clients, even when toughness and strong medicine might be more appropriate. Cost saving ideas might be copied from other company staff. The number of audits carried out in comparison with those planned might say something. But then again, IA might limit the number of planned audits to make it look like it was doing more than it is. IA is in the service sector, and services are by their very nature different from products and tangible assets and difficult to measure.

Interestingly, IIA Inc has never issued Standards or Practice Advisories dealing with performance measurement. Even Sawyer (2003), widely recognized as one of the founding fathers and author of "Sawyer's Internal Auditing" – a 1400 pages standard book for internal auditors – does not address more than a few pages to performance metrics (2003, 1017-1019). He concludes (2003, 1018): "Productivity in service operations such as internal auditing is difficult to measure because …" He then goes on to include a list of qualities very similar to the list above.

The second issue deals with how to reward the Chief Audit Executive. Even less has been said about that. Chief Audit Executive's are often high ranked officers in organizations the matter of rewarding him is left in the hands of management. Not a syllable is to be found in the Standards or the Practice Advisories. Sawyer is also mum on the subject. A Basel Committee survey (2002b) revealed that no performance or profit-related remuneration of internal auditors within the surveyed banks were to be seen (see Chapter 3 on this issue). This in itself is remarkable, because Agency Theory would predict that applying the right incentives has the proper motivation results with Chief Audit Executive's. It is my firm belief that properly designed and installed incentive programs will foster Chief Audit Executive productivity. This will include performance related rewards.

The third issue is who should appraise the Chief Audit Executive? IIA Inc (2003b) came up with a number of research questions aimed at addressing this area. The underlying question is whether this needs to be the Supervisory Board/Audit Committee or the Management Board. As mentioned above, this will depend on who the Chief Audit Executive reports to. The reader should know by now my answer: the Supervisory Board/Audit Committee.

The IIA Inc. Standards refer to the issue of quality control and a number of measures that should be taken.

- Adherence by the Chief Audit Executive and staff to the Standards and referring to them in the course of activities.
- Make sure proficiency is taken care of and training programs are in place.
- Make use of a quality assurance program and assessment.
- Internal reviews
- An external assessment once every five-years by a qualified independent reviewer.

For Dutch internal auditors who are member of professional bodies, such as NIVRA or the *Vereniging van Operational Auditors* (VRO, Association of Operational Auditors), disciplinary powers are also applicable. Interestingly enough, the VRO has never used disciplinary powers. The NIVRA does keep statistics. I have kept up with the professional literature but cannot recall more than a few isolated cases where internal auditors were scrutinized. Such powers are not part of the IIA Inc. Standards.

Very little has been said about how and who should appraise and reward the Chief Audit Executive. There is much ground for further research, as is also demonstrated by the IIA Inc (2003b). In Chapter 3, Agency Theory is brought to bear on the matter.

2.6 Scope of Services

Scope of Services of the Internal Audit Function

This section will deal with the scope of services in general and the shift from financial to operational audit in particular. Traditionally, internal audits focused on finances, as should be more than abundantly clear by now. The Dutch roots lie in the era before World War II. The role of the internal auditor could be typified as an internal accountant. The annual account was certified internally, after which an external auditor, supported by the work of his internal colleague, could sign off on the annual report. There was a large overlap in the scope of services of internal and external audit.

Sinnott (1957, 28-29) presented his view about IA's tasks. Its main focus would be detecting and preventing theft, fraud or any other loss of a similar nature. But it would also detect and prevent other errors, and continuously appraise internal checks. It would detect and report non-compliance with financial regulations and accounting instructions. It would also make suggestions for improving systems and methods, presenting financial and statistical data, and increasing income.

Stokvis (1957, 48) provided a view from The Netherlands. The internal auditor should be commissioned to:

- Give his expert opinion on the internal financial statements.
- Judge the efficiency of the accounting system
- Provide management with all information within the orbit of his specialized knowledge, which in his opinion could be of assistance in running the business, especially regarding planning and delegation the duties of subordinate executives and control over the performance of delegated tasks.

These views clearly mark the general perception of internal auditing 50 years ago. While it has definitely gone out of style in some businesses, it has continued in numerous nations and businesses in one form or another up until now. Sometimes overtly in the text of job descriptions and contracts, sometimes covertly in the subtext of un-stated, and perhaps not even consciously realized, expectations.

It is fair to say that IA's scope of services remained rather stable from 1957 onwards to in the 1980's. From then on, the shift from financial towards operational auditing was apparent. A 1991 NIVRA survey conducted among 87 internal auditors supported this view: 76% of the respondents had noticed a shift from financial to operational audit. Since at that time the scope of services dated back to 1985, NIVRA's findings didn't pick up on more recent developments or mass scale jumping on a fashionable bandwagon. Sixty two percent of the respondents indicated that certifying the annual account formed only a part of their scope of services. This is noteworthy, because 85% of the respondents considered a combination of financial and operational audit important. According to that survey, financial audit was still ahead of operational.

The already mentioned ICAS paper (1993) also addressed IA's scope of services and objectives. The paper made clear that IA should aim at reporting whether management information and internal control systems have been, one, established and maintained and, two, whether they are sufficiently reliable and contributing to:

- Provide the true and fair information necessary for preparing financial statements.
- Contribute to the information necessary for the board to be able to judge whether, given the environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least 12 months from the date the directors approve the financial statements.
- Minimize opportunities for fraud and other illegal acts and maximize the likelihood that the directors will quickly detect any such irregularities.

According to this, the ICAS clearly envisions financial audit as the proper work terrain of IA, which in itself contradicted the developments already noticed in the late 80's and early 90's.

In the middle of the nineties a number of studies and publications emerged. According to Van Lieshout (1994), halfway through the 1980's there was in the US a shift from financial to operational audit. While he vaguely hinted that this trend had something to do with changes in international accounting practices, he didn't get any more specific than that. According to a study by Breedveld-Krans (1990), 90% of the organizations studied had their IA performing both operational and financial audits. Ekelschot (1993) and De Jaeger (1995) also noticed this trend towards operational auditing. Other organizations had fully outsourced the financial audit to external auditors. This often led to either axing IA or a deeper and broader focus on operational processes.

A number of surveys provided data supporting this trend. They are (NIVRA, 1991; IIA The Netherlands, 1998 and 2002) presented in the table below. A few significant differences, which are indicated, hinder comparison. The table includes the average time spent on any service.

Table 2-8: Time spend by the IAF

	Financial audit	Operatio-nal audit	Compliance audit	Other
Average time spend 1991	46%	32%	**	22%*
Average time spend 1998***	30%	51%	9%	10%
Average time spend 2000****	22%	45%	9%	24%****

* IT accounted for 12%
** not specified
*** no IT included
**** IT accounted for 16%

The problem is that no reference was made to IT auditing, making a comparison very difficult. Although the percentage for operational audits went up significantly (from 32 to 51, falling slightly back to 45) and the percentage for financial audit decreased from 46 to 30 and then to 22, this might be due to the fact that EDP audit was categorized under operational auditing in the second study. Despite this shift, almost 80% of IA's still performed some financial audits and expected that this would still be the case 5 years hence. A total absence of financial audit is not to be expected.

The ground gained for operational audit assignments is obvious. This is further demonstrated by a VRO study (1998). Out of its 29 respondents, 7 indicated that they had started operational auditing activities in the 80's. The remaining 22 started in the 90's.

There may be two explanations for this development, both originating in the Anglo-Saxon world. One was the publication of the COSO report in 1992 and 1994. The other was the surge of the corporate governance debate in the 90's (to be discussed in more detail in Chapter 4).

The publication in 1992 of the COSO report highlighted the importance of internal controls, and went a long way towards nailing down what that means (see Van Lieshout above). As outlined above, the emphasis was initially placed on optimizing operational processes. After the COSO report was published this shifted, due to the broadening of the concept "internal control", towards statements of being "in control" and "risk management". McNamee (1997) published an article proposing a changing approach directed at COSO and with a primary focus on "business risk" instead of an internal control system. In his conclusion he stated that "the differences between the old and the new paradigm may appear subtle; nevertheless, the risk-based audit process is broader and richer in information content." (1997, 27)

International literature also indicates that the audit increasingly takes shape as an internal control function. McCuaig (1998) indicates that the added value of an internal auditor lies primarily in assurance as intended in the COSO report and the corporate governance debate.

In The Netherlands the term operational audit is used to describe the differences in scope of services. Paape (1999)[16] argued to change "operational auditing" into Management Control System Auditing (MCSA), because management considers it important to have a second opinion about how well the Management Control System (MCS) is functioning. This call was repeated in 2005 (Paape, De Korte, Otten). The call was backed up by explaining that the term "operational auditing" tends to cause confusion among users of IA, because it connotes operational processes. Further, the new term would better mark off the main area of focus. That is, pay more attention to management control. For an auditor it means that he must be capable of studying management control systems and their components. This subject will be returned to in Chapter 3.

Paape, Scheffe and Snoep (2003) also surveyed IA's scope of services among the Chief Audit Executive's of the largest companies in the EU. They discovered that the predominant service was operational audits (97%), which is consistent with several other studies already discussed. A high number (64%) was also found for consulting activities. The consultative service delivery is strongly linked to the desire to deliver added value to management. The IIA Inc developed its new Competency Framework in 1999 via – among others – a Delphi study and a survey among internal auditors globally. Out of that it became apparent that consultative services seemed to be valued more by superiors and, therefore, deserved a prominent place in the framework. Consulting has been pushed forward as a valuable and viable service, but not without debate.

Having read numerous IIA Inc publications (1999a, 1999b, 1999c, 2000, 2001a, 2001b, 2001c, 2002b, 2002c, 2002d, 2002e, 2002f, 2002g, 2002h, 2003a, 2003b, 2003c to name just a few) and IIA Nederland (2001) and research reports, I noticed that many of them contain reference to the added value dogma about consultative services. The image of a profession almost desperately searching to be heard and valued springs to mind. It isn't too far fetched to compare that mindset with what has been happening in the external audit profession. They have been criticized with regard to their "one stop shopping" concept and focus on consultancy services. It led regulators to impose a ban on certain services and led to the sale of many of the consultancy services by KPMG, Ernst & Young, PricewaterhouseCoopers and Deloitte. At first sight similarities are easily found and it may not be that surprising that the same was happening in the internal audit community. In this respect the framework provided by Matthyssens et al (1998) at the end of this section is certainly worth examining and pondering.

[16] L. Paape (1999), "OA, MCSA?!?! *Over de toekomst van OA*", pp 293-304. Dissatisfactions with the term "operational auditing" are aired. Included are the potentially limiting association with operational aspects; the too large emphasis on the control of the performance of the work by Anthony; and the definition of operational being too much influenced by ambiguities and the desire to expand the task of the auditor to opinion forming around MCS.

It is also worth noting the differences of opinion regarding the "legitimacy" of consultancy services (in relation to the independence issue). While more than half of the respondents in the study of Paape et al (61%) think it is allowed, 23% totally disagree with that contention. The issue bothering the profession is the collusion problem. Will an auditor be able to be "objective" about advice he gave when the results of the advice, especially when they are negative, turn up in the course of a subsequent audit? If so, he is a better man than I am. The Standards allow consulting services, but do acknowledge the possibility of it impairing independence and objectivity. They are allowed by the Standards if disclosed before an engagement.

Church and Schneider (1991) researched the "collusion" issue. Students in a university class, having no experience with internal audit, were presented a case and made decisions that suggested an impairment of objectivity. In other words, they were susceptible to the temptations of collusion. Then they presented the same case to experienced internal auditors, who did not make comparable decisions. They concluded that experienced internal auditors maintained their objectivity. This demonstrates that while the danger of collusion is real, experienced internal auditors know how to handle it. Results like this might help to demonstrate that experience is a sort of inoculation against the illness of collusion.

Consultancy services also appeared to be an issue in The Conference Board research. Asked about their expectations with regard to consulting services, The Chief Audit Executive's surveyed reported a marked increase in that area. The areas covered ranged from vulnerability assessments to executive compensation reviews and quality control functions. Unfortunately, the survey did not inquire about the time spent on consulting services.

The collusion issue is also connected to broadening the scope of services. In earlier stages of the profession's development the area of expertise was quite clearly financial audit. . An auditor's education had everything to do with accounting and finance. Consulting was okay, as long as it was restricted to these areas. It was like going into an ice cream shop and being told you could have whatever flavor you wanted, as long as it was plain vanilla. The spread of the service pallet, however, made expertise less obvious, and service expansionism - sometimes known as "empire building" - more seductive. If one wants to be perceived as a value adder, one may be enticed to promote the image of expertise in areas where wise men would fear to tread. In other words, the issue might be getting more complicated.

Van der Woerd (2003) advocates the need for adding consultancy to more traditional services. His argument is that the two are necessary, and needn't be obstructive. He suggests that consultancy engagements should not be mixed up and reports about those engagements are solely provided only to the lower level managers, not to the Management Board. He also advocates a strict separation of staff and does not allow an auditor or consultant to be involved in a subsequent audit of a previous consulting engagement where he was involved.

De Korte (2003) and Paape et al (2005) tried to solve the issue of possible collusion between consulting and auditing activities. Their conclusion was that consulting should preferably take place at the beginning of any audit. In preparing the criteria to be used during the audit, the internal auditor is well placed to discuss with management the preferred set up of the internal control system. That is the time to demonstrate his knowledge and expertise and make it available for management. This will prevent uncomfortable surprises - "guess what we found?" - at the end of the audit and will also promote acceptance.

Another interesting topic is the question whether top management activities should be subject to internal audit. Stokvis (1957, 50), supporting the idea that IA should receive instructions only from top-management (see above), was clear on the subject.

> He should, therefore, be allowed to take cognizance of all documents which reflect the decisions of management, e.g., minutes, budgets, etc. If his findings give rise to any comment on top-management's activities, he should be able to report directly to the CEO and to any or all of the managing directors, thus ensuring that his position has the greatest possible independence within the organization.

Sinnott (1957, 32) felt a bit more reluctant about this issue and would leave the matter to the discretion of management.

> If on the other hand, the scope of his activities is restricted to exclude top management, he can quite properly leave this field to the external auditor, having made his own restricted position clear to that auditor and having proffered advice on the appropriate internal check.

Back then the issue of including top management activities in the scope of services was controversial. Nowadays, much is said about the "soft controls" and the "tone at the top". Verschoor (1992) reported that 65% of Chief Audit Executive's submitted information concerning the results of monitoring the corporate code of conduct or ethics to the Audit Committee.

Jules Muis (2003) was quite clear. "For the internal audit profession to suggest that 360 degrees reviews of corporate governance dynamics is easily within its professional reach – including 'tone at the top auditing' – is a dangerous illusion." (2003, 48) The newly adjusted IIA Inc. Standards – which came into effect on January 1, 2004 – made a giant leap forward by including Standard 2130.A1. "The internal audit activity should evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs and activities." Although one might approach this from a systemic perspective and not bring the "tone at the top" under this umbrella, expectations are clearly rising.

But the clock might be turned back. While writing this thesis, the Sarbanes- Oxley Act came into effect, and the outcome with regard to the scope of services is becoming more and more apparent. Gray (2004) studied its impact on internal auditing. It may be significant. "Internal audit departments are shifting away from consulting and operational auditing and returning to their traditional financial auditing activities. In terms of status, they are now reporting directly to the audit committee and play a greater role in the audit committee's meeting agenda." (2004, xvi) He continued: "In terms of reporting relationships, usually there is a 'solid line' from the internal audit department to the audit committee, reflecting a functional relationship, and a 'dotted line' to the CFO (sometimes the CEO), reflecting an administrative relationship." (2004, page xx)

In conclusion, the shift from financial to operational audit is obvious. The increasing breadth of the scope of services is also visible, and consulting, prominent in the IIA Inc's definition of internal auditing, while still subject to debate, is on the rise. The tone at the top and codes of conduct have, via the revised Standards, recently been appointed an area to include in the Scope of Services.

There seems to be an underlying trend, which emerges when taking a bird's eye view of the data and having been around in the profession for a while. The internal audit profession has always been an instrument in the hands of management and sought for its approval and recognition. Since it has never been mandatory, it had an inherent need to deliver value for money to management. Either that, or be shown the door. Marketers can tell you all about creating first a desire for products and services, and then a need.

Starting off with its focus on financial audit, working closely with the external auditor and providing assurance on the financial data, it sought to expand its services to other areas. This trend can be explained using the framework provided by Matthyssens et al (1998). They presented the following model.

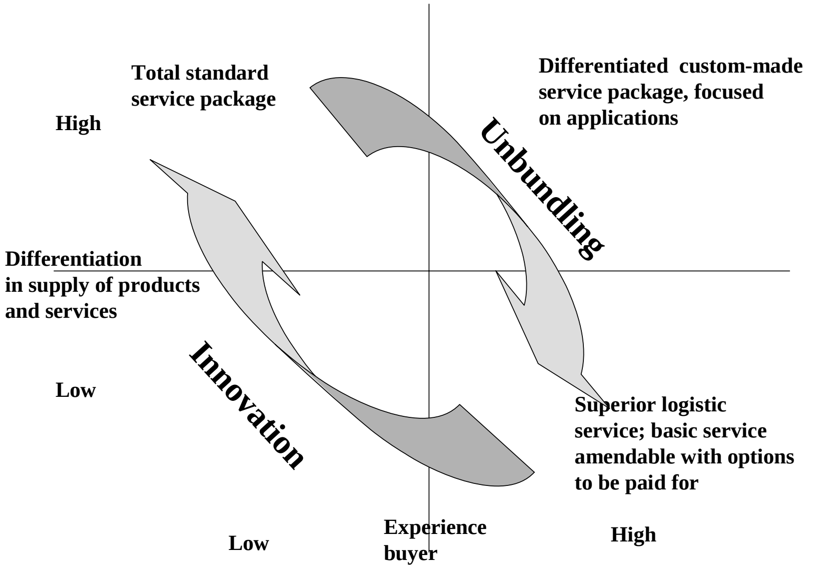

Figure 5: Matthyssens et al (1998, 33): Service and Market evolution

This scheme shows that from a standard package there will be a trend toward differentiation of services, which winds up in superior services, which, in turn, can become a new commodity, which requires innovation to adapt to the changing needs of customers. The convolutions of that sentence demonstrate the potential ongoingness of this process.

This development may be relevant to IA's scope of services. The financial audit became a commodity, which was also provided by the external auditor. This competitive force led IA along the path of differentiation and finding new services, such as operational audit, IT audit, compliance audit, and the like. Adding consulting services increased the service pallet even more. The question whether this trend could be called "push", whereby the profession started this trend, or "pull", whereby management demanded other services, might be difficult to answer. If one would were to plot the current status of the internal audit services in this scheme, the best estimate probably would be the right upper quadrant. A highly differentiated service spectrum aimed at different needs and different applications. Whether the trend continues into the right lower quadrant remains to be seen. Interestingly enough, albeit from a totally different objective, Wyatt and Gaa (2004) described a similar development for the public (external auditor) profession.

If applying the Matthyssens et al (1998) model to internal audit services is valid, this might explain the trends shown by the data above. It would also enable us to come up with some possible predictions with regard to the service portfolio and learn from others. Matthyssens et al use their model to demonstrate how added value of services can be achieved and what needs to be done. They also demonstrate that differentiation in itself may induce high costs and requires skills other than are needed for a standardized basic service. Applying this to internal audit, it might also explain the increased need for higher and ongoing education of auditors - the *education permanente* mentioned above, or the concepts of "tour of duty" and multidisciplinary IA's to be able to deliver the differentiated services portfolio.

They also foretell that on the road to add value to services and tread the "unbundling" road, one must take into account three "building blocks".

1. Processes and systems that will facilitate superior service delivery and provide performance measurements to control it.
2. Unique skills necessary to run projects, account management and managing interfaces.
3. Culture - human resources and organization - aimed at transparency, a learning organization, empowerment and a market driven culture.

Questions such as "what services add value?", "what costs are involved?" and "how to improve the effectiveness and efficiency of services rendered"' are not easily answered. As shown in an earlier section, the performance measurement of internal audit services is rather poorly developed. This might be explained by the lack of a competitive market. In other words, the internal audit profession has a virtual monopoly. But if and when this competition heats up and becomes fierce, this might become a handicap that the profession will have to deal with.

Internal auditors do have a unique skill set, but a much-heard argument by management and Audit Committee members is the perceived lack of business and customer focus. As might be expected in a situation of a kind of monopoly, the need to have a customer focus might be less developed than would be needed in case of a real market. Account management and developing relationships are attributed more to the External Auditor than IA. IIA Inc (2002c) said it eloquently. "If there is no universal answer to what adds most value, then the way to answer that question for yourself seems obvious: 'Ask your stakeholders!'" (xiii). Interestingly, this IIA Inc study, which aimed at investigating the added value area, revealed that the list of changes was headed by a change from "confrontational approach to partnering with line management (xv)".

Hiding behind arguments like "professional judgment" and a culture of a closed shop - ascribed to many professional service providers - might not be the best road to run. Empowerment requires spreading power, information, knowledge and rewards (Matthyssens et al, 1998, 241). The concepts of multidisciplinary IA's to be able to address the broadened scope of services and to recruit management potentials (tour of duty), although widespread as ideas, are in reality not easy to achieve.

The list of 14 major changes in IA services - expected and expressed by 11 thought leaders during interviews in an IIA Inc study (2002c) - contained a number of items that line up with the above. Shifting from Assurance services to Consulting; adding more value; staffing via internal transfers with broader skills; the use of technology (automated work papers, E-commerce, etc.); applying knowledge sharing; and expanded areas of auditing (such as environmental auditing, etc.).

These changes fit neatly in the three "building blocks" above. The study included a survey and case studies backing up the trends mentioned in the interviews by the thought leaders.

One of the dangers, foretold by Matthyssens et al (1998, 152), is the danger of what they call the "non-committal route", whereby services offered are uncoupled and unbundled. This will attract buyers who shop for a bargain. To go the other, and harder, route, focusing on adding value, services need to be coherent and aimed at solving the problems of customers. Their call is to create a customer oriented philosophy and a strategy and organization that is aligned and able to measure their performance and progress. From the perspective of the difficulties with performance measurement of IA services, this could be a real challenge.

Relations between Internal and External Auditors

The last part of this section will deal with the relationship between the internal and external auditor. Coming from the same background and, in The Netherlands, being members of the same professional body, there is still room for improvement. The professional rivalry between them is gossiped about at social gatherings and paved with prejudice and platitudes. It is high time that some quality research was devoted to the topic.

Walker (1957, 11) notes that "each must stay out of the other's road" and that the coverage of the internal auditor may reduce the detail work necessary to satisfy the external auditor of the existence of adequate internal control. Irish remarks that: "Effective coordination is practicable only if the external auditor is satisfied as to the competence of the internal audit staff and that its status and accountability within the organization ensure integrity of results" (1957, 15). He also envisions the external auditor as having '*de facto* jurisdiction' over IA.

Walker's call to include the external auditor in the planning process of the internal auditor is very much in line with Tabaksblat (2003), who describes as best practice that the external auditor should be "involved" in the planning process. Since "involved" is not clarified, that might be anything between being informed and given a say in the process. At least there is some ground to suppose that it is more than just sending the plan to the external auditor for his perusal, and provides grounds for the idea that the external auditors could in some ways impact IA. At least in the eyes of Tabaksblat.

It seems that not much has changed in the last 50 years. Irish goes so far as to say that "the public [external] auditor is placed in a position of psychological seniority; the internal auditor is impressed more indelibly with the duty he must feel towards him and the significance of the work he is doing" (1957, 16). He calls for a system of licensing and means for penalizing internal auditors if they fail to comply with duties as established by external auditors. This in itself is in tune with the findings in the literature discussed in Chapter 3. Since there are professional, and in some respects psychological, tensions between the professions - "separated by a common language" - having them mutually agree on work plans and a mutual review process would enhance the quality of the work of both of them. There is no other way of bringing this about than cooperation.

MacPherson (1957, 24-25) sees many possibilities for that. But the most important for him is reducing the shareholders' auditor's (that is, the external auditor) attention to transaction details, thus freeing him to devote more time to assets and liabilities, analyzing operations, and appraising the fairness of the financial statements. He goes on to say: "The external auditor cannot accept the work of the internal auditor as part of his own; he cannot merge the internal audit staff temporarily with his and as his own." Sinnott (1957, 32-33) cites the Institute of Chartered Accountants in England and Wales in a publication of 1953 that the statutory auditor may:

- Derive much assistance from the internal auditor's intimate knowledge of the accounting system and technical knowledge of the business.
- When satisfied that the internal auditor has adequately covered part of the work, be able to reduce the extent of his detailed examination.
- Be able to rely to a large extent on the internal auditors in determining whether the system of internal checks is operating satisfactorily and in assessing the reliability of the accounting records.

The AICPA Standard 65 ("The Auditor's Consideration of the Internal Audit function in an Audit of Financial Statements"), which refers to the standards of the IIA Inc. and acknowledges IA as a profession, specifically addresses the coordination between internal and external auditor. This should include periodic meetings, scheduling audit work, providing access to internal auditors' working papers, reviewing audit reports, and discussing possible accounting and auditing issues. The first version of SAS 65 was published in April 1991 and was commented on by Jarvis and Moran (1992), two internal auditors.

> At last, an SAS has been released that recognizes the strides internal auditing has made as a profession and provides that the external auditor may use the professional internal auditing standards as criteria in making the assessment of competence and objectivity. (1992, 51)

Not surprisingly, Verschoor (1992) in his study came up with the fact that 94% of Audit Committee's discussed coordinating activities of both internal and external auditor.

Reviewing SAS 65, Braiotta and Marsh (1992) came to the conclusion that the work performed by internal auditors can help the external auditor in planning their audit. "This constructive relationship between the internal and the external auditors will assist the board of directors through its audit committee to effectively oversee the audit processes and the financial reporting process." (1992, 11)

This statement is backed up by a study by Schneider and Wilner (1991), which presented hypothetical cases to 264 study participants. One group was told that the company was not audited at all; a second that it was audited by a competent staff of internal auditors. A third that it was audited by competent staff of outside independent external auditors. Each group was confronted with three independent short case histories, including several factors expected to impact the effectiveness of auditing as a deterrent to not above board financial reports. Their conclusion was – perhaps surprising to some - that both internal and external audit had a similar clear deterrent effects on financial reporting irregularities, thus indicating that at least for some tasks IA is a viable substitute for the usually more expensive external auditing. "This could lead to an expanded role for the internal auditor in the audit process." (1991, 31)

Following the implementation of SAS 65, Vessel (1991) studied this issue and concluded:

> It is time for internal auditors to stop frustrating themselves by pursuing recognition and acceptance through being designated a profession. If the goal of the pursuit is a higher level of reliance on internal auditors work by external auditors, then the pursuit is futile. Rejecting internal auditors' claim to professional equality appears to be in the external auditors best interest at this time. Therefore, internal auditors need to accept themselves and appreciate the very essential roles that they are currently playing in their organizations. (1991, 92)

Following up the ICAS paper (1993), McInnes and Stevenson (1995) also commented on this relationship. They concluded that the Cadbury Committee (see Chapter 4) required companies to have a sound system of internal control and that IA is best suited to provide the assurance needed by management. They external auditor would not be best suited for many reasons. Among them, he might lost sight of his main responsibility: the statutory audit.

The Standards of the IIA Inc also provide guidance pertaining to coordinating with the external auditor. Standard 2050 specified:

> The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

IIA Inc also provides Practice Advisories (PA) for internal auditors, serving as a beacon, but having no binding power. One of them, PA 2050-1,[17] covers the same ground as SAS 65 and goes further. The PA says that the Chief Audit Executive can support the board in its efforts to assess the performance of external auditors, and specifies the areas to look at. For those who have been following the story so far and the frankly demeaning opinions of some contributors to the debate, this plot turn may seem like a bolt from the blue.

[17] www.theiia.org/iia/index.cfm?act=content

But, according to Agency Theory, as outlined in Chapter 4, cross-checking between the auditors is a logical and sound practice. The contract between the external auditor and a company is an "incomplete" contract in every way. First because the company and its management will lack the specialist knowledge necessary to fully comprehend the work of the external auditor. Second because the external auditor must live up to professional standards that almost by definition (and perhaps by intent) will not be easily understood by management of the contracting party. Third, the often used mantra "professional judgment" will even further throw smoke into the eyes of the contracting party. It takes a professional to understand the essentials of the methodologies and techniques used by an external auditor. And as already mentioned, measuring performance of the external auditor is no easier than that of the internal auditor. In short, the contracting party will need a professional capable of judging the completeness of the contract sign and the level of services delivered.

It is also in the best interests of external auditors to have a professional partner on the inside to discuss technical issues. This will enable them to better assess not only needs, but also potential problems and difficulties they may encounter during the assignment. Obviously, this inside partner will be the internal auditor. Agency Theory predicts that principal-agent relationships create information asymmetry, which impacts the principal - especially in circumstances of incomplete contracts. The dangers of opportunism, discussed so eloquently by Williamson (see Chapter 4), also arise. After all, who is to say whether or not the contract was fulfilled in its entirety?

Surely, this uncertainty and potential for lingering suspicions are also not in the best interests of the external auditor. The contract will benefit from a relationship in which each - the external and internal auditors – oversees the other. One potential danger is mutual blackmail or collusion between the parties. "You scratch my back and I'll scratch yours." These dangers are very real. Agency Theory requires another watch dog or countervailing powers to limit these risks.

The external audit profession has imposed on itself many measures, such as oversight, peer reviews, disciplinary powers, educational programs and requirements for ongoing training. Contracting companies can also sue for liabilities. All of the above create pressure for External Auditor to measure up to its reputation. There are no such restraints and incentives on IA. Disciplinary measures are possible if the internal auditor is a member of the NIVRA or the VRO. But, as we have already noted above (2.4), they are hardly ever used.

The IIA Inc does not have disciplinary powers. It created the need for quality assurance and external reviews at least once every five years, but has no credible measures to check and enforce adherence to external review. If the outcome of such a review were negative, there are no provisions to correct non-adherence to Standards. The last resort would be dismissal. Between June 27 and July 8, 2003, the IIA Inc[18] surveyed via their website whether internal auditors had undergone an external quality review and the results were shocking. Out of 380 respondents, a mere 27% answered positive, 2% planned one for 2003, 9% planned one for 2004, and a staggeringly 61% had not done so and did not have any plans to do so. Again, the Standards make such a review mandatory. This poll shows the need for enforcing power and could – or should - be reported to the board by the external auditor. A mitigating factor might be that many IA's, especially those in the financial services industry, are scrutinized by regulators on a regular basis and might rightfully claim to have undergone external reviews. For the others, no excusable factors are available.

A 1999 IIA The Netherlands study showed large differences from firm to firm in the relationship between internal and external auditor. The most significant difference was that some_IA's were heavily involved in certifying the annual report, and others were not. As might be expected, those that were worked more intensively with the external auditor.
The Basel Committee has published several papers about auditors in general and IA in particular (2001, 2002a, 2002c, 2003). It carried out a survey (2002b) among banks in the EU to determine the relationship of the Supervisory Board to both external and internal auditors. It revealed that all regulators were aware of the importance of regular meetings between external and internal auditors. In the financial services industry, regulators monitor financial institutions and their IA's. Therefore, regulators actively seek to engage with internal auditors via onsite meetings and evaluations, reporting directly to the supervisor. This is also the kind of contact Koster of the AFM has in mind (se above).

An IIA Inc poll,[19] conducted between December 2003 and January 2004, showed that out of 1074 respondents 51% were involved in the year-end work of the external auditor. The study revealed that respondents expected that the external auditor would include operational auditing in his approach and there would be a greater need to coordinate activities. One of the drivers is Corporate Governance regulations, and especially the US' Sarbanes-Oxley Act, that will require internal auditors to include financial audits more than they have done in the recent past. In a November 2003 poll[20] of the IIA Inc, 907 respondents were asked what percentage of internal audits had shifted from operational audit to financial and compliance audit. There is an undeniable turning back of the clock! About 37% mentioned that more than 25% of their work had already shifted from operational audit to financial and compliance audits.

[18] www.theiia.org/iia/index.cfm?doc_id=3837

[19] www.theiia.org/iia/index.cfm?doc_id=3837

[20] www.theiia.org/iia/index.cfm?act=content.print&doc_id=4495

The AICPA issued an exposure draft, "Proposed Statement on Standards for Attestation Engagements: Reporting on an Entity's Internal Control over Financial Reporting" (2003). This exposure draft followed the Sarbanes-Oxley Act and was issued to provide guidance for external auditors. The tone of the text is that external audit should be able to fulfil its responsibilities vis-à-vis the provisions of Sarbanes-Oxley. The most provocative remark was: "The practitioner should **not** [emphasis added] rely on the results of internal auditors' procedures as the principal evidence of the operation effectiveness of controls over significant accounts, classes of transactions, and disclosures." (para 51)

If the external auditor intends to use the results of tests performed by others - such as internal auditors - he should:

> Re-perform tests of controls on each significant account, class of transactions, and disclosures to corroborate the results of such tests; and also perform independent tests of controls related to each significant account, class of transactions, and disclosure. (para 74)

If it were finalized unchanged, this exposure draft would have a profound impact on the relationship between internal and external auditor. If such a proposal came into effect, it would seriously devalue the work, prestige and professionalism of IA and, perhaps not coincidentally, enhance all of the above for external auditors and thus increase their bargaining power. But it would also significantly increase the amount of work to be done by them – with the concomitant hours – and lead toward as yet uncalculated inefficiencies. If any companies are interested in this no win approach, they will be in a distinct minority.

2.7 Conclusions

The foundations of (internal) auditing go back a long way. Nevertheless, up till now theory around internal auditing is limited. Legitimization seems to be found predominantly in Agency Theory. Some critics, like Power (1997) and Pentland (2000), question the validity of auditing and accuse it of obscurity. Having studied the different elements of auditing and its state of affairs, it is at least fair to say that there is more than *prima facie* merit in their critique.

Auditing theory, focusing mainly on the financial audit, aims at providing assurance on a certain subject. That assurance is based on an assessment of the current state of affairs, as compared with a predefined state called "the norm" or "criteria". An audit should have benefits, and there should be interested parties in need of the assessments of the auditor. In addition to knowledge and expertise, one of the main features of an auditor is independence. He is not supposed to have an interest in the outcome of his work that will bias his conclusion. Nor is he supposed to have a relationship with the parties involved that would create a possible conflict of interests.

The latter issue is especially problematic for an internal auditor, because he is part of the organization and, therefore, more than just incidentally tied to his supervisors. Thus it is all but impossible for him to fulfill the conditions of independence or avoid potential charges of conflict of interests. Independence is a much debated issue. Does it have inherent value? Or is it the result of something else, like objectivity and integrity? IIA Inc believes it is the cornerstone of the profession. Some, like Jules Muis (2003), contend it is its fatal flaw. In either case, defining independence is not easy. Some say it is all about professionalism, due care, competence, objectivity, probity of character, integrity, and the like. The external auditor profession developed many pages of rules cookbooks to try to come up with ideas about what might impair independence. The internal audit profession has a principle-based perspective and a framework and process to deal with the issue. Has it been resolved? No.

Within the much debated issue of independence is the much debated issue of organizational position. The bottom line is who the Chief Audit Executive reports to. IA has always been an instrument in the hands of the Management Board. But due to Corporate Governance changes the Supervisory Board/Audit Committee is coming to the fore. In order to deal with what seems to me to be inevitable, and to a large extent intolerable, contradictions that have emerged as the way of doing things have changed over time, the profession and its masters have twisted, squirmed and come up with monstrous and barely comprehensible distinctions between "administrative" and "functional" reporting lines. Which does more to muddy the waters than make them limpid with light.

It's time to take a stand and affirm that the responsibility for IA should be taken by the Audit Committee. The IIA Inc in its 1120-2 describes it as follows:

> The IIA believes strongly that to achieve necessary independence, the Chief Audit Executive should report functionally to the audit committee or its equivalent (IIA, 2004, 55).

Many Chief Audit Executives like the idea. Drifting in the arms of the Supervisory Board/Audit Committee would seem to strengthen their independence vis-à-vis top management. However, there is a catch: a big one. As IA becomes more independent of the Management Board and more dependent on the Supervisory Board/Audit Committee, it might wind up more often in that the Dutch describe as "between the dock and the ship", and the Americans as "between a rock and a hard place". IA might wind up having to serve two masters or, if Koster (2003) has his way, three.

Solving the independence issue via outsourcing IA and having it done by an "outsider" – thought to be inherently more independent – is clearly not the answer. Because many of the advantages of having an IAF - such as knowledge of the organization and its culture, and being perceived as "one of us" - would go out the window with the whole department. What's more, who will it be bought from. The firm's external auditor is currently prohibited from providing many of the IA services. Hiring yet another outside company increases the number of participants on the playing field and increases coordination efforts and costs.

The animosity between external and internal auditors is a social gathering subject and reflected in the professional debate via the make or buy decision. The make or buy issue is exacerbating these traditional tensions. There are pro's and con's. As we will see in Chapter 4, Transaction Cost Economics predicts that a higher level of Asset Specificity increases the make decision. Agency Theory predicts the same when there is a high level on Information Asymmetry. Although a lot has been said about outsourcing (the buy option) there is no evidence that it is actually increasing. There also isn't any evidence the other way around.

At present the make or buy issue is much ado about nothing. Whether the turning back of the clock towards financial audit and the shift in organizational position and drifting into the arms of the Audit Committee will move the scales in one direction or another remains to be seen. In the meantime, it is in the best interests of both external and internal auditors to closely cooperate and coordinate their activities. It will not only strengthen service payoff and reduce cost savings, but also demonstrate true grown up professionalism. It will also make the Audit Committees job, of supervising both, easier.

The external auditor is an instrument in the hands of shareholder and the Supervisory Board to monitor the Management Board, mainly via signing off on the annual accounts. Hired by the Supervisory Board - though having his point of entry via the Management Board and corporate officers - he also deals with the internal auditor.

The broadening of the Scope of Services is evident. Differentiation of the services portfolio and thereby ‘adding value’ is promulgated by the IIA Inc for the last decade. The question is whether this was due to a "push" strategy on behalf of the profession or a "pull" strategy by its masters. Marketing pointed at the most secure route to professionalism. Three building blocks are affected and need to be taken into account: processes and systems; skill set; the culture; and human resources and organization.

The needs of the public at large and therefore those of Supervisory Boards, is shifting towards assurance on the reliability of financial data. This may lead to an overlap between the work of the internal and the external auditor, creating an increased need to coordinate their efforts. Although the shift from financial audit towards operational audit has undeniably been the trend of the last two decades, there seems to be some turning point. Again, Sarbanes Oxley might have stopped the pace of the development of consultancy services. Whether this is for the short or the long term remains to be seen.

Corporate Governance regulations have gained pace during the last decade of the 20th century. These regulations have also had an impact on the internal audit profession and contributed to the status and its prestige. I am convinced that this development is far from over and, therefore, still subject to ongoing research. IA is being called to the fore because of an Audit Committees need to supervise what is going on. In the case of companies listed at the NYSE, an IA is now mandatory, and the emphasis on a proper internal control system may also push up the numbers of IA's. Although there is a trend towards regulatory requirements for an IA, the lack of such has not hampered the development of the profession. In the next chapter we will explore developments in Corporate Governance regulations and their impact on IA.

The heightened status comes at a price. IA has to increase its credibility and live up to expectations. Is it up to the task? The IA profession has been around for a long time without being able - or having - to define its "uniqueness" and back up its *raison d'être* and right to operate. Some existential uncertainty has come and gone and the profession has always come squarely down on the side of management. When management said "Jump!", the first response was "How high?". And the rationale for that was simple. "Management needs us and, therefore we are a legitimate function." And up to now that has been more than ample justification.

After flying over the Corporate Governance landscape in Chapter 3 we will proceed in Chapter 4 to theory for answers and more interesting questions.

Chapter 3. Corporate Governance and Internal Audit

> "No effort of any kind is called for. You go to a meeting once a month in a car supplied by the organization. You look both grave and sage, on two occasions say 'I agree', say "I don't think so" once, and if all goes well you get 500 pounds a year. If you have five of them, it is total heaven, like having a permanent hot bath."[21]

> "Over twenty years – through various attempts to reform the governance of corporations and their directors – [Paul] O'Neill kept getting nudged toward the same conclusion: It was all about the Chief Executive Officer. 'The solution is to make the Chief Executive Officer responsible for the company he runs. Period,' he said. 'And I mean legally responsible. Everything else will flow from that. The accountants will either do their job or the Chief Executive Officer will have to fire them – he can't take the risk. That goes for the senior executives, too. And for the Board. Tie a high standard of accountability to the man in charge, and everyone will fall into line.'
> "[Alan] Greenspan sat for a moment, turning it around in his head. 'You may be right,' he said. 'But I'm not sure if it's not a little more complex than that.' He paused. 'Then, again, it may be the thoughtful solution. Nothing else has worked.'"[22]

3.1 Introduction

In Chapter 2 we studied the current state of internal auditing. One of the driving forces for shaping internal audit and its functioning in organizations is Corporate Governance. The number of reports issued during the last decade is large. Moreover, the subject of internal audit – as will be shown in this chapter – has been increasingly addressed over the years.

Gregory et al (2002) did a comparative analysis of Corporate Governance codes in the member states of the European Union (EU) and defined a Corporate Governance code as: "a non-binding set of principles, standards or best practices, issued by a collective body, and relating to the internal governance of corporations". Many codes are issued from a broad array of groups -- governmental or quasi-governmental entities; committees (or commissions) organized by governments or by stock exchanges; business, industry and academic associations; directors associations; and investor-related groups. Thus, as one might expect, compliance mechanisms and the "official" status of codes vary widely.

Many are voluntary. Some are indirectly mandatory via stock exchange listing requirements to disclose the degree to which companies comply with code recommendations, along with an explanation of any areas of non-compliance. Some of those codes, or at least parts of them, became embedded in the law. For example, the Sarbanes-Oxley Act in the United States - which will be discussed below - or the *Loi Sécurité Financière* in France. In The Netherlands the Tabaksblat Code begot a semi-legal status via a so-called *Algemene Maatregel van Bestuur* (General Measure of Governance), meaning that in a court of law this code will be used as a reference point for judicial claims.

[21] Quote from Lord Boothby, 1962, addressing a group of Yorkshire clubwomen, concerning board membership. From: L. Herzel, R. Shepro, L. Katz, "Next to Last Word on Endangered Directors", *Harvard Business Review*, January/February 1987, p 38
[22] Ron Suskind, (2004). The Price of Loyalty, p. 210f.

Although many of those codes are predominantly designed for listed companies, some of them are also "translated"[23] to other domains.

The Corporate Governance codes analyzed in this research emanate from different nations. Those differences impact the content of the codes. But globalization puts pressure on systems and has an inbuilt drive for convergence. As will be shown in this chapter, that is exactly what is happening. Further, movers and shakers maintain strong cross border networks. Board members are increasingly internationally active, spreading best practices and experiences globally. Companies call for a "global level playing field" to prevent lack of competitiveness due to incompatible differences in governance systems. Last but not least, corporate scandals also have repercussions beyond narrow country borders.

Gregory et al (2002) have noted: "Given their distinct origins, the codes are remarkable in their similarities, especially in terms of the attitudes they express about the key roles and responsibilities of the supervisory body and the recommendations they make concerning its composition and practices" (2002, 18).

The main aim of those codes is to contribute to the prosperity of companies and proper functioning of capital markets. To that aim, many, if not all, address such areas as the relationship with shareholders, voting rights, Board structures, the use of separate Committees (like the Audit Committee), relationships with auditors, both internal and external, and enforcement mechanisms and compliance. In that respect there is always an "external" element in the codes via defining relationships with stake- and share-holders and the way the company communicates with the market. There is also an "internal" element in the codes via "prescribing" how Boards should be structured and "behave", and the fact that many, if not all, codes strive to strengthen what is called the "internal control system" of the company. The rationale for internal auditors then is to understand and strengthen the internal control system in order to facilitate Corporate Governance in their companies.

Further, many codes require companies to assess and express an opinion of the Board on the adequacy and effectiveness of the "internal control system". In order to do that, they will call upon internal and external auditors.

Corporate Governance originates in Agency Theory (which will be discussed further in Chapter 4) and its foundation is rooted in the need to resolve or mitigate agent-principal issues. Corporate Governance is also an influential factor in studying auditing in general and internal auditing in particular. In fact, corporate scandals and Corporate Governance developments over the last decade were a source of inspiration and *point de départ* for this thesis. This chapter will highlight the most important Corporate Governance developments from the perspective of internal auditing. We will not address all issues, just those that may influence the internal audit profession in general and IA's in particular. We will study the situation in the United States (US), United Kingdom (UK), EU, and last, and definitely least, The Netherlands.

In the Western world there are two mainstream governance systems: the one- and two-tier. The one-tier, which uses one unitary Board, consisting of executives (management) and non-executives, is dominant in the Anglo-American environment and the majority of the member

[23] In The Netherlands there is a "Government Governance" initiative, a "Health Care Governance" initiative and the like, which use ideas comparable with corporate governance codes.

states in the EU. While executives run the organization on a day-to-day basis, strategy and far-reaching decisions are taken by the entire Board. The Board appoints several committees, including those in charge of Remuneration[24], Audit[25] and Succession[26]. The other is the two-tier system, where Supervisory Board and Management Board are separated. This system is dominant in a few European countries, such as Austria, Denmark, Germany, and The Netherlands.

Although the two vary, the similarities in actual board practices are significant. Both types of systems recognize a supervisory function and a managerial function, although the distinctions between them tend to be more formalized in the two-tier structure. Typically, both the unitary board and the Supervisory Board appoint the members of the managerial body - either the Management Board in the two-tier system, or a group of managers to whom the unitary board delegates authority in the unitary system. In addition, both the unitary board and the Supervisory Board are usually responsible for ensuring that financial reporting and control systems are functioning adequately and the corporation is in compliance with law.

Each board system has its own merits. The one-tier system may be preferred for the closer relationship and better information flow between the supervisory and managerial bodies. The two-tier system, however, has a clearer, formal separation between the Supervisory Board body and those being "supervised", the Management Board. Quite often, the Supervisory Board uses many of the same committees as used by its one-tier brethren. This thesis is written from the perspective of the two-tier system. Figure 1, shown in Chapter 1, illustrated the two-tier system.

Both of those two systems have their own fair share of faults and have suffered major break downs. What's more, there is also a conventional distinction between rule-based and principle-based systems. Rule-based has a tendency to prescribe clearly what the rules are that should be adhered to. Principle-based systems aim for more broadly defined principles, which allows those subject to them more leeway to find their own solutions. It is generally assumed that the Anglo-Saxon world is an example of rule-based and the EU one of a principle-based system. While this generalization has been more or less true up to now, convergence is happening in this area as well, as this chapter will attempt to demonstrate.

Before starting off with the analysis of the Corporate Governance codes we have to keep in mind that such is done is done from the perspective of what is most relevant for IA. Therefore, this analysis is limited by nature.

3.2 What is Corporate Governance?

It is generally accepted that Berle and Means (1932) are the founders of the issue of Corporate Governance. In the decades following their first steps economists of the caliber of Williamson (1975), Fama (1980, 1983), Fama and Jensen (1983), and Jensen and Meckling (1976) addressed the issue of separation of ownership and control, and developed Agency Theory, which will be extensively discussed in Chapter 4. Corporate Governance is an agency problem *pur sang* (*par excellence*). Agency Theory says that monitors (Supervisory

[24] A Remuneration Committee deals with remuneration issues.
[25] See Chapter 1.
[26] A Succession Committee deals with succession planning of Board members.

Board/Audit Committee members, auditors, etc.) should be independent of those monitored (Management Board). They also need to be experts in their tasks. Therefore, auditors have an important role to play in the area of Corporate Governance.

The Organization for Economic Co-operation and Development (OECD) published its vision about Corporate Governance in 1999.[27]

> One key element in improving economic efficiency is corporate governance, which involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently. (OECD, 1999, 11)

One should remember that the OECD Principles don't include even glancing references to Internal Audit.

Van Manen (1999, 25) defined Corporate Governance as a process whereby stakeholders try to influence the decision-making process of an organization and its subsequent implementation. Many other definitions can be found in numerous publications devoted to this subject. Mouthaan (2000) swears by the definition of the Toronto Stock Exchange.

> Corporate governance means the process and structure used to direct and manage business and affairs of the corporations with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The directors of the business should take into account the impact on other stakeholders, such as employees, customers, suppliers and communities.

Perhaps the simplest and most common definition of this sort is provided by the Cadbury Report (1992), which is frequently quoted or paraphrased: "Corporate governance is the system by which businesses are directed and controlled." For the sake of this thesis I would like to adhere to this definition.

> After studying the issue of corporate governance, McKinsey published its conclusions in July 2002. They concluded that "high governance standards" are valued by investors, and they are willing to pay a premium up to 30% in Eastern Europe and Africa.[28]

[27] It was revised in December 2004. The basics, however, did not change.

[28] "An overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14% in North America and Western Europe; 20-25% in Asia and Latin America; and over 30% in Eastern Europe and Africa." (Global Investor Opinion Survey: Key Findings, July 2002)

Cohen, Krishnamoorty, and Wright (2002, 579) noticed that auditors "are considered part of the corporate governance mosaic because they monitor the quality of the financial reporting process". While they were referring to the external auditor, this could be applied to the internal auditor as well. They studied the impact of Corporate Governance factors on the audit process and interviewed 36 external auditors. They concluded that in connection with assignment acceptance and planning and risk estimation, the auditors considered such Corporate Governance factors as the presence of audit committees, the tone at the top, and board composition as important for their estimate of the risk involved in an engagement. The same authors had another interesting observation about Internal Audit.

Although 90% of respondents indicated that internal audit could potentially affect the strength of corporate governance, they [the external auditors] did not place a corresponding high level of emphasis on its importance …. This lack of emphasis could also be a function of the relatively infrequent and perhaps ineffective interactions between the internal audit department and the audit committee (Read and Raghunandan, 2001). Moreover, internal audit departments are perceived to be focused on a micro level rather than on overall corporate operations or controls, where the external auditor is most concerned. (Cohen, Krishnamoorty and Wright, 2002, 585)

Van Ees, Postma and De Boer (2002) noticed that economic theory teaches that a good working corporate governance regime has a positive influence on the organizational results in three ways. One, effective corporate governance leads to lower transaction costs. Two, to lower agency costs. Three, to a better use of relation specific investments (2002, 27). They examined a large number of empirical studies on that issue and came to the following conclusion:

> We have again summarized the results of empirical research with regard to the relation between corporate governance and organizational performance.… From the analysis of these results it cannot be concluded that the results unambiguously confirm the theory. (2002, 27)

Referring to Meckling and Jensen (1976), Klijnsmit (2002) stated that, if properly executed, auditing may very well lead to a decrease in total agency costs. Klijnsmit also stated that managers voluntarily hire external third parties, such as auditors, to provide quality checks on governance and disclosure, and thus reduce transaction costs of the investors by increasing their own bonding costs. There is a pay off for incurring either monitoring or bonding costs, because investors/shareholders and the like consider that that increases the credibility of the company and has an increasing effect on the value of the company.

3.3 Internal Audit in Corporate Governance publications

This section will discuss the most relevant Corporate Governance publications from the last decade from the perspective of Internal Audit.

United States (US)

The Treadway Committee report, published in 1987, was a response to what had happened to many small savings & loans banks. Despite the fact that they had all been professionally audited, and in the eyes of the public at large were thus granted a clean bill of health, they went bankrupt. How could that happen? One of the findings of the Treadway Committee was that although auditors were present and annual reports were signed off on, that was not the same thing as a clean bill of health. In other words, while those were necessary components of any sound monitoring system, they were far from sufficient. The Committee found many flaws in the control systems of many of those banks, which led to bankruptcy. These control failures were the source of flawed information provided to Boards and, consequently, risks were not adequately covered.

Not surprisingly, the Treadway Committee concluded that one of the major causes of the rampant bankruptcies was the lack of sound internal control systems. The Committee invited professional bodies and other interested parties to come up with ideas to increase the quality of those systems. Subsequently, a number of professional bodies, such as the IIA Inc. and the American Institute of Certified Public Accountants, formed what they called "The Sponsoring Committee of Sponsoring Organizations of the Treadway Committee". They called it COSO for short. COSO took up where Treadway left off and in its 1992 report, "Internal Control: Integrated Framework", clarified what internal control is.

> Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
> - Effectiveness and efficiency of operations;
> - Reliability of financial reporting;
> - Compliance with applicable laws and regulations. (COSO, 1992, 3)

To substantiate internal control, the report itself had two parts. The first part is the explanation of the core concepts of the COSO model. The second part is a lengthy check list of more than 1000 questions, which enables readers to have some reference points to come to grips with such an amorphous concept as "internal control".
Since then the COSO report has been widely recognized and its definition is taken as a starting point for almost all reports where control is discussed. Practically speaking, it is embedded, and if there is a world standard, COSO is it.

In the COSO-developed model attention is paid to internal audit at the monitoring level. Considering that IIA Inc. made a substantial contribution to its contents, this is hardly surprising. Internal Audit is considered to be a provider of insights in the daily practices of organizations. This vision is consistent with Agency Theory, which shows that internal audit has a monitoring (or bonding) function. The chapter that discusses the roles and responsibilities of numerous players also pays attention to internal audit. One of the relevant remarks is: "the scope of internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of the performance in carrying out assigned responsibilities" (COSO, 1992, 88).

COSO continues to emphasize that "potentially" all activities are within the scope of the internal auditors' responsibilities. COSO stressed even back then that the selection and dismissal of the director of internal auditing - also known as the Chief Audit Executive (Chief Audit Executive) - should occur only with concurrence of the board of directors or audit committee, and that internal audit should have access to the board or audit committee.

While COSO subscribed to the vision of the IIA Inc., it did so without clearly indicating what Internal Audit's tasks should be, and who or what it should report to. As explained in Chapter 2, this impacts the whole issue of independence and objectivity. In a one lump sum Board of Directors - the one-tier system - where principals (or their representatives) rub elbows and share the same executive bathrooms with agents, it is all too easy to lose sight of the fact that the right hand is supposed to be monitoring what the left hand is doing.

In 1994 there was a follow up discussion about whether or not there should be mandatory reporting about the extent and quality of internal controls. But nothing came of it. Then, for a long time, more of the same nothing happened. It seemed as if a hush had been pulled over the whole matter and everyone went about their business as usual, somehow hoping that the whole problem would go away, and maybe even imaging that it had. Notable exceptions to that trend were the Blue Ribbon Committee (1999) and The Conference Board (2003).

The former, an advisory board set up by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) published its findings in 1999.

> A prosperous and well functioning system exists, therefore, when the three main groups responsible for financial reporting -- the full board including the audit committee, financial management including the internal auditors, and the outside auditors -- form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight. However, in the view of the Committee, the audit committee must be "first among equals" in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the processes.

The Blue Ribbon Committee (1999) also stated that management, and not the Audit Committee, should directly monitor internal audit. Of course management should be supported in this task and, therefore, the Audit Committee should regularly review the relationship between management and both the external and internal auditors. Specifically, the Audit Committee should encourage procedures that promote accountability among all these players. That is, management should properly develop, and adhere to, a sound system of internal controls. Internal Audit should objectively assess management's accounting practices and internal controls. And the external auditors, through their own review, should assess the practices of both management and internal audit.

The Blue Ribbon Committee (1999) also acknowledged that there was some risk that management might be too much in charge of determining exactly what internal audit audited.

> The internal auditor occupies a unique position -- he or she is "employed" by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions, but the auditor's "dependence" on management for employment is clear. Recognizing this tension, the Committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit

committee and the internal auditor should lose its "taboo" nature and no longer imply treason against management. The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recognition that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee.

Thus, while the Audit Committee is not the only client of internal audit, it should sharply supervise its activities. Apparently, the Blue Ribbon Committee took into account the risk of "he who pays the piper calls the tune". That is, management might use its not inconsiderable powers to postpone, undermine or hijack potentially tricky and even dangerous IA investigations and reports. Their response to that problem was to require the Audit Committee to supervise IA activities. As admirable and far reaching as their solution is - and if we were holding up the cards at the Olympics, we'd give them a 9 or a 9.5 - it does place Internal Audit in a rather awkward position. That is something we referred to in Chapter 2 and will come back to in more detail later.

While outsourcing (buy) is an option, the Blue Ribbon Committee (1999) noted, it is not preferred.

> Such outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the federal banking agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior managers with the impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.[29]

With regard to the financial sector, specific rules apply under the Federal Deposit and Insurance Companies (FDIC) Act. With regard to internal audit, it was indicated that each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The board of directors (in a one-tier environment) and senior management is responsible for having an effective system of internal controls - including an effective IA - and ensuring that the importance of internal control is understood and respected throughout the organization. But the FDIC Act is also not clear about who the Chief Audit Executive should report to.

> Accordingly, the manager of internal audit should report directly to the board of directors or its audit committee, which should oversee the internal audit function.

The Blue Ribbon Committee's train of thought can also be found in *Commission on Public Trust and Private Enterprise*, a 2003 publication of The Conference Board, the second of the above mentioned exceptions to the hush trend around internal controls. A non-profit organization comprised of top business leaders, The Conference Board presents opinions on many topics. It stated in its 2003 report that all companies should have IA, regardless of whether it is an in-house function (make), or performed by an outside accounting firm (buy).

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[29] FDIC Financial Institution Letter (FIL--133--97), dated December 22, 1997; http://www.fdic.gov/news/news/inactivefinancial/1997/fil97133.html

One caveat about the "external internal auditor" is that the firm should not be the company's regular external auditors.

The Conference Board (2003, 11) also concluded:

> The internal auditor should have a direct line of communication and reporting responsibility to the audit committee, and he or she should attend all regularly scheduled audit committee meetings, report on the status of audits conducted by the internal audit group, report to the committee on other matters that the internal auditor, in his or her judgment, believes should be brought to the audit committee's attention, and meet with the audit committee in executive session.

The Conference Board (2003) referred to the New York Stock Exchange Listing Rules. The NYSE, as a consequence of the Sarbanes-Oxley Act – discussed in more detail below - required all listed companies to have IA. It went on to say that the Audit Committee should support the Board in evaluating the performance of both the internal and external auditors. In order to do this, procedures should include a regular meeting with internal audit. As shown above, The Conference Board also recommended more responsibilities for the Audit Committee, especially with regard to Internal Audit.

While finding the optimal solution to the problem of preventing management from monopolizing the tunes that IA is to play is unlikely to be reached soon, there is a clear trend toward having the Audit Committee take more direct responsibility to reduce that risk. However slowly, the Audit Committee is gaining ground as far as supervising IA is concerned. But placing IA completely under its control seems like not just one bridge too far, but many. As one rather surprising response to the very idea - heard during the case studies - indicates.

The NYSE guideline that each listed company should have an IAF is top notch and state of the art. This is the first time that such a function has been incorporated in a regulation pertaining to organizations other than financial institutions. The Audit Committee should also look at IA staffing, budget, and scope of services. With regard to the obligatory nature of having IA, the NYSE notes:

> This requirement does not necessarily mean that a company must establish a separate internal audit department or dedicate employees to the task on a full-time basis; it is enough for a company to have in place an appropriate control process for reviewing and approving its internal transactions and accounting. A company may choose to outsource this function to a firm other than its independent auditor.[30]

This statement led Bill Bishop, the late president of IIA Inc. to let loose the following victory whoop:

> We just received the press release on the new New York Stock Exchange listing requirements - they specifically say that "Every listed company must have an internal audit function" and go on to say this is to clarify that it is intended to be a requirement - a direct result of our letter I'm sure. This is a great victory and also means that our

[30] Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee, As Approved by the New York Stock Exchange Board of Directors, August 1, 2002.

> profession now really must step up to the task. Standards and guidance, certification, research, quality, and professional development are all impacted. Setting up an audit department will be necessary in many organizations and we had already begun developing a program for this. It remains to be seen if this will make us "regulated". [31]

In the US the most radical act on Corporate Governance in the last decades has undoubtedly been the passage of the already frequently mentioned Sarbanes-Oxley Act. Hot on the Achilles' heels of such scandals as Enron and WorldCom, the US Senate rushed through this bill into law in July 2002 with an unprecedented vote of 522 for. 3 against (with 9 abstaining). But Sarbanes-Oxley does not mention anything about the position and role of internal audit, except for the fact that external auditors are not to perform both external and internal audit functions for the same organization at the same time. But even that stipulation has been weakened by a SEC specification. In the process of drafting the Act, the US Congress and Senate held numerous hearings and received many comments.

One of them was issued by IIA Inc. (2002d). Among its proposed governance principles was one[32] whereby IA would be made mandatory for public companies, and it should report directly to the Audit Committee. One has to keep in mind that from the two-tier perspective this would be a subcommittee of the Supervisory Board. In this position paper the IIA Inc. played its cards and made clear that they believe the Chief Audit Executive should be responsible to the Audit Committee. Further, in its position paper to the Congress, issued April 8, 2002, the IIA Inc. stated:

> Internal auditors and audit committees are mutually supportive. Consideration of the work of internal auditors is essential for the audit committee to gain a complete understanding of an organization's operations.… In establishing and providing oversight for the internal audit function, audit committees should charge Chief Audit Executives with the responsibility of ensuring that internal auditing work is performed in accordance with The IIA Standards. Internal auditors - and especially Chief Audit Executives - should demonstrate their professional competency by attaining appropriate professional certifications.

Although Sarbanes-Oxley did not provide such a provision, some tendency in that direction is visible in one of the SEC proposals about further guidelines for the act, when the following questions were raised. "Should the audit committee also be directly responsible for the appointment, compensation, retention and oversight of an issuer's internal auditor? Should other responsibilities be under the supervision of the audit committee?"[33] But they never openly declared that the Audit Committee should take full responsibility for Internal Audit. The situation in the UK, as the next section shows, is quite different.

The IIA Inc. (2002d) also urged for companies reporting on the adequacy and effectiveness of their internal control systems. They referred to the FDIC Act, which requires financial institutions to do just that. It contended that half of the companies already reported on that matter in their annual reports. But their study also showed lack of clarity.

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[31] Email from Bill Bishop, the late President of the IIA Inc., in August 2002.

[32] All public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee. A position paper presented by The Institute of Internal Auditors to the U.S. Congress, April 8, 2002.

33 Proposed Rule: Standards Relating To Listed Company Audit Committees, February 18, 2003.

The study also found that among those companies that do such reporting, it generally lacks consistency and usually fails to provide an assessment of the control system's effectiveness. Further, public reporting on controls generally is limited to accounting controls concerning financial reporting and does not address the issue of organizational risks.

Needless to say, the IIA Inc. was in favor of broadening reporting across the board of internal control systems, and that internal auditors should be among those providing the necessary assurance. At the end of the day, the Sarbanes-Oxley Act did not go along with any of these requests.

But Sarbanes-Oxley most definitely lit fires under the chairs of chairmen and other officers, because there are severe penalties[34] for possible non compliance. Since its enactment the SEC and the Public Company Accounting Oversight Board (PCAOB) have drafted numerous pages with elaborations and furtherance of its meaning and impact. They in its turn were closely followed by professional organizations, such as the American Institute of Certified Public Accountants (AICPA) and the IIA Inc.

Although Sarbanes-Oxley did not go along with the requests of the IIA Inc. there is one important provision that came close. The Board has to sign off on the adequacy and effectiveness of internal controls regarding *financial reporting* - the so-called Section 404 statement. Statement 404 requires not only the Board to sign off, but the external auditor as well. If we take a good look at the definition of internal controls provided by COSO, we will notice that of the three main elements financial reporting is just one.

But that in itself is already a large undertaking for any company. In December 2004, the Big Four[35], issued a 48 page report to help financial market participants understand issues related to the new internal control reports mandated by Section 404 of the Sarbanes-Oxley Act, and the implementing regulations of the SEC and PCAOB. This report referred to the public statement of the PCAOB with regard to the "reasonable assurance" that is achieved through the "404".

> Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. (Public Company Accounting Oversight Board Standard No. 2, para. 16)

The impact of Sarbanes-Oxley on the audit community in general and the internal audit community in particular is tremendous. The IIA Inc. issued a research report in 2004 and came up with an extensive list. The main consequences included: increasing external audit fees by as much as 100%; the giant step backwards – already noted at the end of Chapter 2 –

[34] Maximum penalties of up to 20 years of imprisonment if Board members willingly violated the provisions of the Act.

[35] Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP, issued *Perspectives on Internal Control Reporting: A Resource for Financial Market Participants*, which contains frequently asked questions about Sarbanes-Oxley Act 404 requirements.

in IA's scope of services towards traditional financial auditing; and the changing relationships between parties, such as the Board and the Audit Committee, the internal and the external auditor, and the Board and the external auditor.

The words that come to mind with regard to the changing relationships are best described by "more distant and formal". Whether that will be an ongoing new status quo remains to be seen. Internal auditors may expect to be confronted with a change in image. During the last decade they have focused on being (or becoming) a management aid. But it is now predicted that there will be "a shift back to company police officers instead of the desired image of partners or consultants" (IIA, 2004, xxi). On the other hand, the effect on the relationship with the Audit Committee is more promising. The report mentioned that internal auditors were more frequently on the agenda of the Audit Committee and that there is a "solid line" from IA to the Audit Committee "reflecting a *functional* relationship, and a 'dotted line' to the Chief Financial Officer (sometimes the Chief Executive Officer), reflecting an *administrative* relationship". The emphasis on both functional and administrative is in the report: not added by me. Now, a functional relationship presupposes that the Audit Committee is to be seen as the party bearing the responsibility for the IA. The report doesn't elaborate on the question whether this is a contention by the internal auditors involved and surveyed in the study or a factual situation corroborated by the Audit Charters and real life.

The relationship of IA with the external auditor is also affected. The reports mentioned the strengthening of their relationship and mutual support, also enhanced by the fact that they have become less competitive due to the ban on internal audit services provided by the current external auditor. As wonderful as that sounds there may be some drawbacks. The AICPA issued an exposure draft: *Proposed Statement on Standards for Attestation Engagements; Reporting on an Entity's Internal Control over Financial Reporting* (March 8, 2003). Following Sarbanes-Oxley, this was issued to provide guidance for external auditors. The tenor of the text is that external auditors should be able to fulfill their responsibilities with regard to the provisions of Sarbanes-Oxley. The most provocative remark was: "The practitioner should *not* [emphasis added] rely on the results of internal auditors' procedures as the principal evidence of the operation effectiveness of controls over significant accounts, classes of transactions, and disclosures." (para 51) If he nevertheless intends to use the results of tests performed by others (such as internal auditors), the practitioner should:

> Re-perform tests of controls on each significant account, class of transactions, and disclosures to corroborate the results of such tests; and also perform independent tests of controls related to each significant account, class of transactions, and disclosure. (para 74)

If finalized unchanged, this would have a profound impact on the relationship between internal and external auditor. If such a proposal comes into effect, it would seriously undermine the work, prestige and professionalism of Internal Audit and, perhaps not coincidentally, enhance all of the above for external auditors and their bargaining power. But it would also significantly increase the amount of work to be done by them – with the concomitant hours – and lead toward as yet uncalculated costs. If any companies are interested in this loose approach, they will be in a distinct minority.

The scope of services is also impacted. At the end of Chapter 2 we noticed a shift from operational to financial audit. This trend is underscored and almost made a permanent fixture by this report. "Back to basics", some may call it. Others a "strategic advance to the rear" - US

Army slang for "retreat". This clearly affects the hiring of internal auditors and which skills will be emphasized in schools and resumes; more financial than operational and consulting. Further, internal auditors noticed that salaries went up, budgets were increased and the report exclaimed almost in exaltation the very same words Bill Bishop emailed after reading the mandatory status of Internal Audit for listed companies at the NYSE:

> During this research project, many words were associated with Sarbanes-Oxley, including paradigm shift, profound, scary, disruptive, changing corporate cultures, time-consuming, and expensive. Most of those words are usually considered pejorative, but as this research report will illustrate, those words represent unprecedented opportunities for internal auditors to increase their visibility, status, and value in their companies. (IIA Inc., 2004, xv)

Whether this is for the better or worse is in the eyes of the beholder, and which position he is looking from. In any case, the jury is still out. The relevant point here is that these profound changes all seem to be directly attributable to Sarbanes-Oxley. One question that comes up is, "Why did we need a law?". Weren't internal auditors able to stand up, speak out, and be heard before Sarbanes-Oxley? Shouldn't those changes have been happening long before the scandals occurred? Are those changes another example of IA's penchant for "riding the waves of change" and adding to the chaotic status sketched out in Chapter 2?

The final remarks of the executive summary of the IIA report referred to the "fluid image" of internal audit. In some companies the internal auditors acted as team members helping to implement Sarbanes-Oxley. In others they were "advisors" to the project team. And yet they need to assess and test the controls and act as "the police once again". In other words, even with Sarbanes-Oxley there still isn't any solid ground to stand on.

For those who may want to see Sarbanes-Oxley as a toy in the hands of those rule-based lunatics on the other side of the pond, the IIA Inc. report mentioned that its real impact stretches far beyond the boundaries of the US and listed companies. Companies may be headquartered abroad. But as long as they have securities traded in the United States they have to be Sarbanes-Oxley compliant. Banks, creditors and government agencies are imposing (part of) the Sarbanes-Oxley Act requirements on private companies as a condition for obtaining loans or government contracts. If in the future a company wants to sell a subsidiary to (or be taken over by) a United States listed company, it had better be Sarbanes-Oxley compliant. After the Ahold and Parmalat disasters, the EU announced a Sarbanes-Oxley look alike. Time to set sail for European soil. First stop, the UK.

United Kingdom (UK)

About the time that COSO was delving into the whys of banks and other businesses "suddenly" going belly up, and what to do about it in the US, the Committee on the Financial Aspects of Corporate Governance got underway in the UK. It came in the wake of some whopping big financial scandals - notably, the collapse of Robert Maxwell's empire and the nearly overnight evaporation of the BCCI - and came to be known as the Cadbury Commission (1992), after its chairman, Lord Cadbury.

No one was particularly amazed that Cadbury's (1992) conclusions were somewhat similar to those arrived at in the US. Namely, that besides the deliberate and massive fraud involved - as, apparently, wasn't the case in the US - there was a clear absence of adequate internal control systems, proper oversight and monitoring, and much of the other modern auditing technologies that keep companies afloat and on course. In other words, something was rotten in the state of UK Corporate Governance.

The Cadbury Report (1992) covered roughly the same subjects as COSO. The biggest difference was that while COSO was a reference framework with no binding strings attached, Cadbury came complete with rules and regulations that were mandatory. One of the more detailed regulations of Cadbury regarding IA's position was:

> It is essential that heads of internal audit should have unrestricted access to the chairman of the audit committee in order to ensure the independence of their position. (Cadbury, 1992, 28)

Cadbury also emphasized the need to have an Audit Committee that can "strengthen the position of the internal audit function, by providing a greater degree of independence from management" (Cadbury, 67). In companies where IA exists, it is also necessary to "review the internal audit program, ensure co-ordination between the internal and external auditors, and ensure that the internal audit function is adequately resourced and has appropriate standing within the Company". Cadbury is also quite specific about who should attend Audit Committee meetings.

> The Finance Director, the Head of Internal Audit, and a representative of the external auditors shall normally attend meetings. The committee should have a discussion with the auditors [both internal and external!], at least once a year, with members present, to ensure that there are no unresolved issues of concern.

While Cadbury (1992) won the race with COSO, as far as its recognition of Internal Audit was concerned, it was only by a nose. And Internal Audit's status and position within the Corporate Governance sphere didn't change as a result of its findings. It didn't change again in 1995 with the Greenbury Report additions. But it did with Hampel (1998) and Turnbull (1999). Hampel stated that companies that "do not already have a separate interna1 audit function should from time to time review the need for one". Turnbull repeated that conclusion almost word for word.

Turnbull incorporated another important element. It stated that companies are accountable for having a "sound system of internal control" in place[36] and that they should elaborate on the effectiveness of such a system. Provision D.2.1 of the Code says:

> The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

This goes far beyond Sarbanes-Oxley since it explicitly focuses on all three elements of COSO: financial, operational and compliance controls (and includes risk management as well). Risk management was included to acknowledge that control systems have to respond to changes in the operating environment.

[36] Provision D.2 of the Code stated: "The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets."

In 1999, the same year as Turnbull, the Institute of Chartered Accountants of England and Wales (ICAEW, the professional body of external auditors) published its own report, *Internal Control: Guidance for Directors on the Combined Code,* which put together and digested the already existing codes. It aimed to assist listed companies in implementing Turnbull's Corporate Governance requirements. It defined the elements of a sound system of internal control and referred to the COSO report by using its definition of internal control. It should reflect its control environment which encompasses its organizational structure and be part of its culture. In that respect if companies are to assess the effectiveness of their control system the culture (or "control environment" as COSO puts it) must be part of the assessment.

It also mentioned that there might be: the possibility of poor judgment in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances, which pretty much sounds like the PCAOB conclusion. Therefore:

> A sound system of internal control provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations (1999, 10).

They stated:

> The need for an internal audit function will vary depending on company-specific factors, including the scale, diversity and complexity of the company's activities and the number of employees, as well as cost/benefit considerations. Senior management and the Board may desire objective assurance and advice on risk and control. An adequately resourced internal audit function (or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned) may provide such assurance and advice. There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues. (1999, 12)

It also addressed the position of IA. When management doesn't have IA online, it needs to use other monitoring processes to assure both itself and the one-tier board that the internal control system is functioning as intended. "In these circumstances, the board will need to assess whether such processes provide sufficient and objective assurance." (1999, 12) According to ICAEW, Internal Audit is an important instrument. Listed companies should have access to such services.

Regarding Internal Audit's scope of services, ICAEW is consistent with Turnbull and COSO. That is, the focus is squarely on the system of internal controls (as defined by COSO). While no explicit statements are made about Internal Audit's position in the organization, it might be supposed that it would be under the auspices of the (full) Board, because they - and not the Audit Committee alone - are the ones who need to ascertain the necessity of such a function and "its scope of work, authority and resources".

Higgs came out in 2003. Yes, that's right. Higgs was yet another chairman of yet another Corporate Governance committee. While Higgs did not pay any special attention to Internal Audit, he did refer to a report from Robert Smith, yet another in the long line of chairmen of committees that reported in the realm of Corporate Governance. Higgs and Smith reported simultaneously. Smith wrote *Audit Committees Combined Code Guidance* (2003) to provide guidance for Audit Committee's about what their position is with regard to the Combined Corporate Governance code. According to Smith, the Audit Committee should monitor and review Internal Audit. Perhaps even more interestingly, he recommends:

> The audit committee should meet with the head of internal audit at least once a year without the presence of management. (2003, 12)

And:

> There should be arrangements for the audit committee to meet with external and internal auditors independently during the year without the presence of management. (2003, 8)

Hampel and Turnbull had already indicated that the one-tier board should ascertain if IA is necessary, and if so, how it should operate. This is a remarkable shift and more important for the future of Internal Audit than most people currently realize. Until Smith no one officially emphasized the need for the Audit Committee to meet the Chief Audit Executive, and definitely not without the presence of management. In that respect, this is the first time that the Chief Audit Executive has been acknowledged as someone the Audit Committee needs to meet with. Smith also increases the pressure to have IA, because if there is none, "the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report" (2003, 11). Since Higgs went along with and mandated Smith's recommendations, they have become part of what in the UK is called the "Combined Code" companies have to comply with. Either that, or elaborate in the annual report why not.

Smith continues:

> The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfill its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors. (2003, 12)

Although Smith does not specifically refer to the IIA Inc. Standards, this is included in the subtext. With regard to the responsibility of the Audit Committee vis-à-vis internal audit, Smith also stated that it should:

> Ensure that the internal auditor has direct access to the one-tier board chairman and the audit committee and is accountable to the audit committee; review and assess the annual internal audit work plan; receive on a periodic basis a report on the results of the internal auditors' work; review and monitor management's responsiveness to the internal auditor's findings and recommendations; meet with the head of internal audit at least once a year without the presence of management; and monitor and assess the

> role and effectiveness of Internal Audit in the context of the company's overall risk management system. (2003, 12)

But this isn't the end of the story. According to Smith, the Audit Committee should also approve the appointment or termination of the Chief Audit Executive (2003, 12). Further, besides attending some Audit Committee meetings, when invited, the Chief Audit Executive has the right to request a meeting with the Audit Committee if he considers that to be necessary (2003, 29). While Smith didn't say it in so many words, it seems to me that he was going beyond implying that the Audit Committee should be largely accountable for IA's performance. The Audit Committee should appoint - indirectly - the Chief Audit Executive. The Chief Audit Executive reports to it, and also has separate meetings with it.

In his report, Smith compared the situation in the UK with those in other countries. His references included the US, France (Bouton report), Australia, Canada, Ireland, and the EU. As far as some regulations are concerned, all of the above have much in common, for example, the Audit Committee monitoring of Internal Audit.

European Union (EU)

Compared with the US or the UK, the EU as a whole doesn't have much of a history of Corporate Governance codes. Up to now those sorts of issues have been the domain of the separate member states. However, following international developments, the EU was nudged into group action. Thus in January 2002 the European Commission published a study done by Gregory et al (2002) comparing the differences in Company Laws in its (then) 15 member states. The law and Corporate Governance initiatives were by no means evenly divided. For example, the UK, led the field with 11 Corporate Governance committee reports and the number increased with Higgs. Almost none of the Corporate Governance initiatives were mandatory. Those that were mandatory were because of stock exchange listing rules, as, for example, the UK.

Of the 35 codes, 25 were published after 1997. This demonstrates, as the McKinsey report cited at the beginning of this chapter indicated, that Corporate Governance discussions and actions have really taken off in the last few years. One of EU's study findings was:

> Notwithstanding legal differences among European Union Member States, the trends toward convergence in corporate governance practices in European Union Member States appear to be both more numerous and more powerful than any trends toward differentiation. In this regard, the codes - together with market pressures - appear to serve as a converging force, by focusing attention and discussion on governance issues, articulating best practiced recommendations and encouraging companies to adopt.

At the EU level there have been a number of studies about the position of the external auditor. In some cases there were even passing remarks about its relation with the internal auditor. For example, in a 1996 EU Green Paper, Internal Audit was positioned as follows:

> However, it is likely that companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfill its responsibilities. The scope of the work of the statutory auditor and the timing of the statutory audit are unlikely to be adequate and appropriate for this purpose.…

> Consequently, recommendations have been made for the appointment in major companies of a chief internal auditor [Chief Audit Executive] to lead a strong internal audit team that is capable of providing the audit committee with sufficient information to fulfill its responsibilities on behalf of the (one-tier) Board.

In the aftermath of the Green Paper the European Confederation of Institutes of Internal Auditors (ECIIA) suggested that:

> Qualitative appraisals, including recommendations for action to improve internal control weaknesses, rectify errors and enhance sound management, can best be provided by a professional internal auditing function. The internal auditing function should report directly to the Chief Executive Officer, Board of Directors or an Audit Committee, in order to ensure necessary status, independence of line management, objectivity and response to recommendations. Internal auditing should preferably be carried out by a department within the enterprise. If special circumstances warrant the use of hired personnel, such services may not be managed by the statutory auditor of the enterprise. (1996, 6)

This is, of course, clear Internal Audit lobbying. That is, preaching to the converted. The murky remark with regard to the reporting issue is striking. Stating that it should report to the Chief Executive Officer, the Board of Directors or an Audit Committee does nothing to diminish the confusion that we have been hammering on.

The ECIIA did not take a clear stand on the reporting issue. One can only guess why such a professional body left this ambiguous issue unaddressed and thus to a certain extent supported the possible conflict of having to serve more than one master. While the ECIIA paper made no direct statement about IA's scope of services, when one reads between the lines it becomes obvious that the entire internal control system should be included. In a 1996 conference[37], Jean Pierre Garitte, then the ECIIA's president, explained it as follows:

> However, the European Confederation of Institutes of Internal Auditors believes that a further step has to be taken. Establishing and maintaining an effective system of internal control calls for skills, which can only be provided through a competent and professionally qualified internal auditing function. An internal auditing function should be made mandatory in all organizations in which size or risk so dictates. (1996, 183)

With regard to the position of Internal Audit, he repeated the ambiguous point of view regarding the reporting issue: "The internal auditing function should report directly to the Chief Executive Officer, Board of Directors, or an Audit Committee in order to ensure necessary status, independence of line management [defined as management in charge of operations and below the Management Board], objectivity, and response to recommendations." (1996, 190)

Seven years later, in 2003, the then ECIIA's president, Ulrich Hahn[38] repeated the same story and added that internal audit should report to the Audit Committee about the entire "control &

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[37] Act of the Conference on The Role, Position and the Liability of the Statutory Auditor within the European Union

[38] European Confederation of Institutes of Internal Auditors Press Release, April 11, 2003, following on a presentation of the Committee on Auditing of the European Commission.

risk environment". The good news is that the ECIIA was invited to the table and asked to participate in an ongoing discussion at the EU level. And while it is difficult to measure how much, they were at least listened to. This is demonstrated by what actually appeared in the Winter Report.

At the end of 2002 the Winter-report[39] came out. Named after its chairman, Jaap Winter, it inventoried the state of the art of Company Law throughout the EU and concluded that there was no need to come up with a unified initiative that would be binding to companies in member states. The report acknowledged the differences from historical perspectives and subsequent differences in legal systems. Tying it together into one system was way beyond what would be possible and, as Winter noted, there was no need to do so.

Some piddling attention was paid to Internal Audit. Winter stated that "a proper audit depends on the role and performance of the external auditor, as well as the internal audit *process* [emphasis added] of the company" (2002, 70). While adding the word "process" was not explained, it might be to emphasize that internal auditing does not necessarily lead to a separate function. According to Winter, the Audit Committee has the explicit task of monitoring Internal Audit procedures and consulting with those responsible for them. And that was all there was to it.

> The audit committee should also be pivotal in the internal aspects of the audit function. To this end, the audit committee should: be responsible for reviewing the accounting policies of the company, and changes thereto; monitor the company's internal audit procedures and its risk management system; meet regularly with those who are responsible for the internal audit procedures and risk management system; consider to what extent the findings of the risk management system should be reported in the company's financial statements; and have access to all internal information relevant to performing its role. (2002, 71)

After Winter had delivered his report the EU promulgated an action plan. In May 2003 Frits Bolkesteijn, EU Commissioner for the Internal Market, put forth his recommendations[40] about what should be done. Listed companies should be required to include in their annual report and accounts a coherent and descriptive statement that covers the key elements of their Corporate Governance structure and practices. If they don't comply, they should explain why they haven't done so. In cases of conflict of interests, the board of directors should be modernized by emphasizing the need to have non-executive members on board. Following Winter's advice, it did not draft a Corporate Governance code at the EU level. The European Economic and Social Committee, a Parliamentary body, underscored this intent[41]. The differences in cultures, laws, and governance systems were believed to be too great, causing a lengthy and agonizing process to come to terms with all the member states.

On December 2, 2002 a statement was issued by the European Shadow Financial Regulatory Committee – part of the Centre for European Policy Studies, an independent policy research

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[39] Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, 4 November 2002, Brussels

[40] Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, Commission of the European Communities, Brussels, May 21, 2005, COM (2003) 284 final.

[41] *Official Journal of the European Union*, March 30, 2004, (COM (2003) 284 final), (2004/C 80/05), page 14.

institute dedicated to producing sound policy research leading to constructive solutions to the challenges facing Europe today. It called for required minimum standards, or "benchmarks", rather than a specific Corporate Governance system. This was supposed to be applicable not only to the then EU member states, but those coming online. That is in countries where Corporate Governance systems were relatively immature.

The European Centre for European Policy Studies set up a Task Force to reform Corporate Governance in the EU. It met twice in 2004, on June 17 and September 30, and underscored the belief that a principle based approach would suit the EU's needs better than the US' rules based approach. It welcomed the OECD code (see above) as a good example. It discussed the issue of the cost of compliance since the number of rules and laws increased. During the second meeting, Peter Wakkie, a member of the Management Board of Ahold, called upon the EU to avoid far reaching and very expensive internal control mechanisms *à la* Sarbanes-Oxley.

Paape, Scheffe, and Snoep (2003) surveyed the issue of Corporate Governance and the impact on the internal audit community throughout the EU. With regard to reporting, they noted that almost half of the responding Chief Audit Executive's reported to the Audit Committee. In Belgium, Greece, Ireland, the UK and Spain these percentages ranged between 80 and 100. But in the other countries the total was significantly less, and ranged between 25 and 67%. In Greece and Luxembourg all respondents reported to the CEO. In Austria and Denmark all respondents reported to the Management Board. Considering that auditing has been traditionally seen as an essentially financial discipline, it is remarkable that relatively few (30%) Chief Audit Executive's reported to the CFO. However, The Netherlands is a striking exception. Almost 90% of Chief Audit Executive's there report to the CFO.

In the context of current Corporate Governance concerns, Paape et al (2003) said that direct reporting of the Chief Audit Executive's to the Audit Committee should be one of Internal Audit's best practices. Nevertheless, they acknowledged that new adjustments might create new expectation gaps and tensions. Since the needs of Audit Committees and Boards of Management are different, Chief Audit Executive's might discover that serving two masters is a difficult, if not impossible, game to play. In this context, Bailey, Gramling and Ramamoorti (2003) also provided food for thought.

> The recommendation [that internal audit should report to the Audit Committee] may create tension with the more traditional role of internal audit as the "eyes and ears" of management. We believe the nature of that tension and the impact of such tension on both the nature of the internal audit activity and its contribution to the organization should be examined. (2003, 32)

More than two thirds of the respondents positioned IA on the corporate level, as a centralized function reporting directly to the Management Board. In other cases, even when IA reported to the Audit Committee, the administrative line rests squarely with the Management Board. This is consistent with the results of a 2003 survey carried out by the IIA Inc. (IIA Inc., 2003a).

Paape (2003) also paid attention to the issue of the relationships and reporting lines of IA and noted:

> it [the IA] could actually become a crossroads of activities, abuzz with traffic coming in and going out in all directions. Internal Audit will need to consider not only the requirements of the Management Board, but also those of the Audit Committee and the external auditor.

Therefore, it can be concluded that with the exception of the UK little can be found in European Corporate Governance codes regarding the position, role and rationale, and scope of services of Internal Audit. The situation is even worse with listing rules; for example, Euronext and Frankfurt. If the proverbial man from Mars used only their codes for his education and orientation, then he would never notice the existence of IA on European soil.

In this context, one conclusion of a KPMG Corporate Governance study in the EU is also relevant.

> Around 85% of respondents from the United Kingdom and Germany reported the existence of an internal audit function. This is to be expected as both the Turnbull report and KonTraG [*Kontrolle und Transparanz Gesetz*], a German corporate governance code that requires listed companies to report on the existence of a risk management system] give a strong steer in this direction. However, many respondents, particularly in Belgium, Switzerland and The Netherlands, do not have such a function. (KPMG, 2001, 4)

There are no stable reference point studies (benchmarks) to assess whether or not there has been an increased percentage of companies with IAF's in the UK and Germany, let alone how quickly that might have happened. Over how many years and in response to what drivers? While as far as all organizations are concerned this KPMG figure of 85% figure seems to be on the high side, there is no doubt that, as far as IA is concerned, these two countries are far ahead of a generally feet dragging pack. While The Netherlands had been in close competition among the *arrière-garde*, over the last few years it has been doing some substantial catching up.

The Netherlands

Specific regulations about Internal Audit have only been established for financial institutions, such as banks, which fall under the supervision of *De Nederlandsche Bank* (the Dutch Central Bank). These mandatory rules can be found in the *Regeling Organisatie Beheersing* (2001) (Regulation Organizational Control). In articles 21 and 22, the Dutch Central Bank stated that an institution should have a permanent IA to systematically test and evaluate the sufficiency of the organizational structure and control mechanisms.

The Dutch Central Bank also wrote about IA's position, role and scope of services, stating that the entire internal control system should be in its purview. According to them and remarkably enough, IA should also pay attention to the areas of integrity and integrity control. It also specifies some of the tasks of the Audit Committee and Supervisory Board and mentions that the Audit Committee should have regular meetings with IA and EA to inform them about its conclusions about their - that is, Internal Audit and external auditor - activities. The specific focus point is organizational structure and the internal control system. The findings of the Audit Committee are also discussed in the plenary Supervisory Board.

After investigating the views of both the Dutch Central Bank and *Autoriteit Financiële Markten* (see Chapters 1 and 2) it became clear that there are more similarities than differences. According to the Dutch Central Bank, IA is mandatory for banks. According to AFM, it should be mandatory for all listed companies. They both emphasized the need for the Supervisory Board and the Audit Committee to exercise oversight and ensure IA independence. As far as organizational position is concerned, it should report directly to the Management Board and have access to the Supervisory Board/Audit Committee if and when necessary.

Outsourcing of IA is not acceptable if it is economically viable to have one in-house. And, according to the Dutch Central Bank, even when the tasks are outsourced, they most assuredly should not be awarded to the firm's external auditor. According to AFM, such a course of action for all listed companies is "not preferred". The scope of services should be broad and take into account financial data and accounting processes. Compliance, integrity and the tone at the top should be addressed as well. The relationship with the external auditor is very important. The external auditor scrutinizes the work of IA and, at the same time, he need to clearly distinguish the differences in their respective scope of services. This is designed to prevent gaps and overlaps.

There are no major differences between the vision of the Dutch Central Bank and AFM. Their joint perspective on supervision was already laid down in a protocol[42]. The only visible exception to this rule is the hiring and firing of the Chief Audit Executive. AFM believes that this should be in the hands of the Supervisory Board instead of the Management Board (Koster 2003).

The financial service industry is faced with specific requirements regarding to internal auditing. Such is not the case elsewhere. What's more, Corporate Governance codes have only a limited history in The Netherlands. It was only in 1997 that the Peters Committee, named after its chairman Jaap Peters, developed the first 40 Corporate Governance recommendations, which were not mandatory. This was in response to developments in surrounding countries, such as the UK, and the perceived need to create Corporate Governance codes there as well. As far as Peters was concerned, IA wasn't worth mentioning.

A 1998 study[43] attempted to determine the effects of the 'Commissie Corporate Governance' (named after its chairman Peters, 1997). That is, to what extent were the players out there going along with with its views. Both the long and the short answer was, "not at all". However, the good news was that large institutional investors and associations of stockholders occasionally took the law into their own hands and criticized Supervisory Boards and Management Boards for not complying with Peters' recommendations.

It took another few years and some critics, like Moerland (2002, 10) and Van Horn (2003, 50), who concluded that Corporate Governance in The Netherlands was getting nowhere, before the government decided it was high time to get the ball rolling.

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42 *Nota Handhavingsbeleid van de Autoriteit Financiële Markten, De Nederlandsche Bank en de Pensioen- & Verzekeringskamer*, November 2003

43 Commissie Corporate Governance en Economisch Instituut Tilburg, (1998). *Monitoring Corporate Governance in Nederland,* onderzoek en aanbevelingen op het gebied van Corporate Governance in opdracht van Amsterdam Exchanges N.V. en Vereniging Effecten Uitgevende Ondernemingen.

In 2002, 5 years after the Peters Committee, the Dutch government appointed a new Committee – named after its chairman, Morris Tabaksblat – to prepare recommendations that would eventually serve as the basis for legislation. Its final report was presented on December 9, 2003, and was immediately and widely recognized as a landmark in the development of Corporate Governance in The Netherlands. With the Tabaksblat Committee Code (2003), The Netherlands caught up with the developments in the US and UK and some surrounding countries, like Germany and France. This is not surprising, because the Committee decided to take a very close look at what was happening outside. For instance, the Code referred to the work of Higgs and decided to include a number of its best practices. It mentioned that the similarities with the UK Combined Code's best practices is quite high because the UK has a longer history in this area than The Netherlands and is thus more advanced.

This also explains why the Code has such a high number of best practices and has a far greater "rules-based" portion than many "principle-based" believers would have imagined possible. The Committee wrote that a pure "principle-based" approach would have offered too little guidance as to the how to implement the Code. In its view, this was one of the reasons the Peters Committee recommendations were little so adhered to. The Committee also referred to the rules laid out by the NYSE and the OECD. The Code used those examples as stepping stones to make large leaps forward.

The Code mentioned the need to restore "checks and balances" and enhance the independence of the Supervisory Board. It expressed the need to have a Supervisory Board that can act critically and independently of the Management Board. It also stated that an Audit Committee should be appointed, and emphasized the joint responsibilities of both the Management Board and Supervisory Board in governing the company. Nevertheless, while it addressed the IA's position and role, it concluded that IA should remain in the hands of the Management Board.

> The internal auditor, who can play an important role in assessing and testing the internal risk management and control systems, shall operate under the responsibility of the management board. (principle V.3, page 31)

The Supervisory Board/Audit Committee, however, is to supervise what the Management Board does with IA. This is an indirect version of supervising IA, and creates a need for the former to be more involved with the latter's activities. According to the Code, the Audit Committee is entitled to decide whether or not the Chief Audit Executive will attend its meetings. In this respect, while the Tabaksblat Code is in step with regulations in the US and UK, it is less far reaching.

In the UK and US the Audit Committee is to directly supervise IA activities. Tabaksblat, made that supervision rather indirect: "The Audit Committee shall in any event focus on supervising the activities of the management board with respect to: … the role and functioning of the internal audit department" (page 21). It also didn't make IA mandatory. Tabaksblat noted best practices were lacking and pointed at the diversity of IAF's.

Tabaksblat's best practice about the relationship of external audit and the Audit Committee to IA reflects somewhat antediluvian thinking.

The external auditor and the audit committee shall be involved in drawing up the work schedule of the internal auditor. They shall also take cognizance of the findings of the internal auditor. (Best practice provision V.3.1, 31)

This statement is not in tune with others quoted above. Audit Committee supervision of IA is indirect, because it is supposed to pay attention to how the Management Board deals with it. And the responsibility for IA rests with the Management Board. What then is the secret magical step that will transform that approach into getting the Audit Committee involved in drawing up IA's work schedule? Taking cognizance of the findings of IA is to be done via either direct contact or reading reports. In either case, if any questions come up, there should be the possibility of discussing those with the Chief Audit Executive. If the Chief Audit Executive is not present during Audit Committee meetings, how exactly should this be accomplished?

The only viable option would be to invite the Chief Audit Executive to all meetings where his findings are at the table. Since this should not be limited to just a few meetings, why not give the Chief Audit Executive a season ticket to all meetings, and exempt him from those where the items on the agenda don't require his presence? Nevertheless, reading the Code and talking to Izeboud - a member of the Tabaksblat Committee - it seems that the Committee aimed at enhancing checks and balances by also allowing for the Supervisory Board/Audit Committee to be in contact with IA. Izeboud specifically mentioned that he believed the Code allowed for a greater visibility and orientation of the Audit Committee for IA. He hoped that organizations would share their perspectives on IA's role, which might be an inspiration for a greater conformity in its role and scope of services for listed companies.

With regard to these risk management and control systems, the Management Board is to disclose their adequacy and effectiveness in the annual report. They should also report on their operation, describe any significant changes that have been made throughout the year, mention planned improvements, and *confirm that they have been discussed with the Audit Committee and the Supervisory Board* (best practice II.1.4, 10, emphasis added). For this purposes, again, the Supervisory Board/Audit Committee could rely on IA, because the Code also stated that it can play an important role in assessing and testing the company's internal risk management and control systems.

During the period that the Code was in draft and open for comments, the IIA The Netherlands noted that although there were differences in the Internal Audit community, a number of similarities had to be taken into account. IA's in The Netherlands focused primarily on internal control systems and were mainly responsible to Management Boards. But there was increasingly contact with Audit Committees. It suggested making IA mandatory for listed companies. Its scope of services should be defined by the Management Board and it should send planning, realization and reports (annotated with comments) of IA to the Audit Committee. The Audit Committee should in turn discuss these in a meeting with the Management Board and Chief Audit Executive present. In task force meetings discussions were held that a formal position more under the jurisdiction of the Audit Committee would be preferable. The majority of the task force – certainly not all – felt this was not a good idea. IA should be loyal to the Management Board and not report to the Audit Committee. The official comments of the IIA The Netherlands send to the Tabaksblat Committee stated that IA should report to the Management Board. The IIA The Netherlands vision did not align with the one from the IIA Inc., who responding to the developments that led to the Sarbanes-Oxley Act in the United States desired for an IAF under the jurisdiction of the Audit Committee[44].

In its detailed comments IIA The Netherlands addressed the growing practice of Chief Audit Executive's meeting with the Audit Committee and being present during its meetings. But the letter specifically stressed the need to remain responsible to the Management Board in order to clarify IA's position. The letter also pointed out that the Audit Committee would be able to call upon IA for its services, albeit with the required foreknowledge of the Management Board. Further, the Chief Audit Executive should have the power to call upon the Audit Committee chairman if he deemed that necessary. Although acknowledging the primacy of the Management Board the IIA The Netherlands paved the way for closer contacts between the Audit Committee and the Chief Audit Executive.

Tabaksblat may also have some impact on the scope of services, following Turnbull, KonTraG, and Sarbanes-Oxley Act by having the Management Board report in the annual report on the adequacy and effectiveness of the internal risk management and control systems and providing clear substantiation of this. Tabaksblat is more attuned with Turnbull than Sarbanes-Oxley because it addresses the full range of internal control rather than the part dealing only with financial reporting. Bearing in mind the enormous costs and efforts needed to comply with Sarbanes-Oxley, one can also ask what it will mean to comply with Tabaksblat.

This is a very broad area of interest, most certainly also for the Audit Committee as described in the best practices for the Audit Committee.

> The Audit Committee shall in any event focus on supervising the activities of the Management Board with respect to the operation of the internal risk management and control systems, including supervision of the enforcement of the relevant legislation and regulations, and supervising the operations of codes of conduct. (Best practice III.5.4, 21)

The Tabaksblat Code acknowledged the importance of "codes of conduct", which could be included in IA's scope of services when assessing and testing internal risk management and control systems on behalf of the Management Board. As we will see in Chapter 5, both Management Board and Supervisory Board members have different opinions on that issue.

In March 2004 the Dutch government decided that the Code in its entirety should be adopted and put immediately into effect as an '*Algemene Maatregel van Bestuur'*, as close to a law as possible. The Tabaksblat Committee also recommended that there should be a permanent panel[45] that decides, when appropriate, on adjustments to the Code. It is expected that this panel will also provide jurisprudence. In other words, this is the beginning of the road, not the end.

Undoubtedly, the situation in The Netherlands cannot be studied *in vacuo*. Capital markets do not stop at national borders. They are highly interconnected and intertwined. Numerous companies are listed on more than one stock exchange and have to comply simultaneously

[44] See the section on Corporate Governance in the United States.

[45] The Monitoring Committee was established in December 2004 to keep track of bottlenecks in the provisions of the Code and possible areas for improvement.

with various laws, codes and regulations. This creates some anxiety - at least from the perspective of companies[46] - that the differences will create the need to adhere to several (not necessarily compatible) systems. Understandably, that is something companies would like to avoid. Therefore, they will recommend that regulators converge whenever possible, because, unlike heads, one system is always better and cheaper than two. As noted above, the urge to converge creates a need to examine more than one set of codes to predict what's going to happen next.

3.4 Some further remarks on the Audit Committee and its relationship with Internal Audit

Regardless of current or imminent regulations, it is still not a given that the Audit Committee will use and supervise IA. As was shown in Chapter 2, Internal Audit has come a long way over the years and its relationship with the Audit Committee has been growing. The audit profession in general[47] and some professionals in particular[48] have frequently pledged to improve the content and intensity of relations between the Audit Committee and IA, because it would both improve the former's understanding of what is happening in an organization and contribute to the "independence" and stature of the latter.

Clearly, the Audit Committee has - via Corporate Governance regulations - been assigned an important task in monitoring and sometimes even directing IA and its activities. The stream of publications with regard to the Audit Committee is large. Sarbanes-Oxley seems to have the farthest-reaching consequences for those organizations falling under the supervision of the SEC, which supervises all listed companies in the US. But its reach extends far beyond US borders.
This Act requires independence and expertise among Audit Committee members and the external auditor. This led *The Wall Street Journal* to write, "The job of the audit committee chairman just got a lot tougher. Will anyone still want it?" [49]

In the fall of 2002 the IIA Inc. sponsored a Corporate Governance conference. One issue addressed was not the standard fare relationship of the Audit Committee and the external auditor with Internal Audit, but something completely different, namely, their relationship with management. One external auditor asked with a palpable sense of frustration, "How do I keep those lines of communications open with management and at the same time report these conversations to the audit committee?" (2003, 29) If this is troubles the external auditor wouldn't it be legitimate to assume that it is equally, if not more, difficult for the Chief Audit Executive?

Long ago, Bagby, Kintzele and Kintzele (1990) voiced a comparable concern when they studied SEC proposals requiring management to publish an annual account regarding its responsibilities. Proposals that before Sarbanes-Oxley sat on shelves gathering dust. One of their findings was:

[46] I discovered at a meeting with a Chief Financial Officer of a company listed on several stock exchanges (United States, London, Euronext) that his worst fear was that the EU would impose its idiosyncratic version of Sarbanes-Oxley, which would require his company to adhere to yet another system.
[47] IIA Inc., (2002, 2003, 2004), The IIA, The Netherlands (2003), AICPA (2002)
[48] Bishop, Hermanson, Lapides and Rittenberg (2000), Wallage (1995, 2000), Paape (2003)
[49] February 24, 2003

> The requirement for disclosure of the internal auditor's "significant recommendations" could chill the free flow of such recommendations. Further, this could affect the written memoranda or formal communications between the internal staff and management. (1990, 60)

Returning to the fall 2002 Corporate Governance conference, one participant brought up the relationship between external and internal auditors.

> Sarbanes-Oxley prohibits external auditors from performing internal auditing for their clients. This should vastly improve the working relationship between these groups, because they will no longer view one another as a potential competitor. (2003, 29)

This belief was confirmed in 2004 in an IIA Inc. study.

Klein (2002) has been only one of many researching the tangled issue of Audit Committee independence. He investigated listed organizations and explained the relationship between "adjusted abnormal accruals" (AAA: in plain English, "cooking the books") and the independence of the members of the Supervisory Board and Audit Committee. He concluded:

> In summary, the results indicate that after holding other factors constant, firms with boards and/or audit committees composed of less than a majority of independent directors are more likely to have larger AAA's than their counterparts.… In contrast, there is no evidence of a systematic association between having an all-independent audit committee and abnormal accruals. (2002, 390)

In short, an independent Audit Committee is more likely to prevent false presentations of annual accounts. Wouldn't it be fair to expect a knock on effect in the right direction when IA is also independent? That is, when an independent Audit Committee includes supervising IA in its scope of services.

The research of Goodwin and Yeo (2001) supports that conclusion. Independent Audit Committees had more direct contact with Chief Audit Executive's, and these meetings happened more frequently without the presence of management. In those cases, the Audit Committee was more actively involved in hiring and firing of the Chief Audit Executive. In a 2002 study, Colbert concluded that external and internal audit have specialty areas of focus. Therefore, both should have direct relations with the Audit Committee.

Apparently, the existence of the Cadbury Code in the UK led to more companies having Audit Committees. And that led to more attention being paid to internal control. The status of the internal control systems improved substantially (Klein, 2002), and external audit fees decreased. This shows that even though actions were more or less compulsory - the shotgun wedding effect - and actually in the short term increased costs, in the long run they paid off. This is one of the burning questions raised by Sarbanes-Oxley. Will it pay off?

In the wake of the Cadbury, Spira (1998) attempted to study the effectiveness of Audit Committees. But he concluded that while there were more post-Cadbury Audit Committees, there was little research about why they existed, how often they met, and communication between members. Thus it was impossible to even approach the question of effectiveness, let alone answer it in any meaningful way.

The value of Audit Committee members being independent of the board is attested to in a number of studies. Carcello and Neal (2000) concluded that Audit Committees should be comprised of independent members. Imhoff (2003) argues for firewalls between Management Boards and Audit Committees. This is very much in tune with Agency Theory.

From the perspective of IA, it is worth noting that in many Corporate Governance codes, Audit Committees are supposed to either directly supervise IA activities or indirectly through their dealings with Management Boards. Either way, internal audit is getting more and more attention from the supervisory level. The downside is that there is some ambiguity that might potentially cause problems that need to be addressed to prevent Internal Audit ending up between a rock and a hard place. One of the ambiguities is that it is not clear who is pulling the strings and calling the shots. Will it be the Audit Committee? The Management Board? Or, worse, both?

3.5 Conclusions

Over the last decade there has been much ado about Corporate Governance in general and supervisors and Audit Committees in particular. Audit Committees have been assigned more responsibilities, which include supervising directly or indirectly internal audit functions or processes.

In the US, internal audit, whether in-house or outsourced, is mandatory for NYSE-listed organizations and those falling under the watchful eyes of the FDIC Act. According to current regulation and proposals, the Audit Committee should be its supervisor. It should also direct its agenda.

In the UK the Combined Code seems to go farther. The Audit Committee has at least some *de facto* responsibility for IA. It should approve the hiring and firing of the Chief Audit Executive. But there's a twist, because IA is not yet obligatory there. The EU has not yet had a big impact on Corporate Governance issues. The Winter Group took some huge steps forward but did not detail many provisions regard IA. Winter did not support the idea that there should be Corporate Governance regulation on an EU level.

As far as Corporate Governance regulations were concerned, The Netherlands was until recently practically in the Third World. But it made some quick marches forward with Tabaksblat and joined the ranks of the front runners. That Code, however, has an ambiguous perspective about IA and its relationship with the Audit Committee. On one hand, the Audit Committee should indirectly supervise its activities by supervising management's activities vis-à-vis it. On the other, it should take some responsibility by having meetings with the Chief Audit Executive, taking notice of his findings and discussing the work plan. The ambiguous pose may be explained by the predominantly two-tier system of Corporate Governance where the Management Board is IA's lord and master, whereas the many one-tier focused reports take the stand that IA should report to the Audit Committee.

The trend is obvious. The Audit Committee and IA are being driven closer to each other, whether they will it or not. Given those mutual responsibilities, sooner or later the two masters' issue will have to be resolved.

As shown, Corporate Governance codes have affected not only IA's position, but also its relationship with the external auditor and scope of services. The "soundness of the internal control system" is to be reported on in annual reports and signed off on by external auditors. Internal auditors are an important source of information on the adequacy and effectiveness of this system. The Sarbanes-Oxley Act Section 404 requirements demonstrate the difficulties that lie ahead. Public statements that the system is adequate and effective will increase credibility and public trust, especially when signed off on by the external auditor.

The main conclusions about IA from this chapter are:

1. Internal Audit is being called to the fore and will need to measure up to heightened expectations.
2. Audit Committees will be installed in many more organizations. Their independence and stature[50] will increase. They will become more involved with IA and intensify their contact the Chief Audit Executive, whether by hiring and firing process or appraisal. Meetings will be more frequent and there might be an increased tensions for Chief Audit Executive's caught between the Management Board and the Supervisory Board/Audit Committee.
3. The Supervisory Board/Audit Committee needs to exercise oversight over both internal and external auditors. Supervisory Board/Audit Committee oversight might impact the principal-agent scheme for IA and the Chief Audit Executive. This might have an effect on the performance measurement system, which in turn might impact the incentives and rewards scheme for Chief Audit Executive's[51]. This development may have a positive effect on IA's perceived "independence".
4. There will be an increased demand for assurance services that might affect budget, staffing, and scope of services.
5. Due to a focus on financial reporting controls desired by legislators, regulators and the public at large, there could be an increased need for financial audit type of work. On the other hand, the Corporate Governance reports tend to emphasize internal control systems. This might necessitate broadening the scope of service of IA's not currently involved with those tasks.
6. Due to a shift towards financial auditing and the need for the Supervisory Board/Audit Committee to oversee the entire audit agenda - both internal and external - the relationship with the external auditor could be affected. Active coordination and cooperation might be just around the corner.
7. There could be a perceived need to emphasize quality systems within IA and comparable measures. Quality control and bureaucracy will definitely be tightened. Being in the spotlight of the Supervisory Board/Audit Committee and even the public at large will lead to more stringent scrutinizing by regulators, supervisors, and the external auditor.

From the perspective of the auditing profession, both external and internal, there is also a tendency towards convergence of perspective, rules and professional standards. The IIA Inc.

[50] The IIA Inc. 2004 study revealed that AC's meet more often and longer. As will be demonstrated in Chapter 5, the world has to some extent been turned upside down. Nowadays, AC meetings take longer than those of the SB. It used to be the other way around.

[51] The IIA Inc. 2004 study revealed an increase in budgets and payment for internal auditors. If these payments were performance related – which Agency Theory recommends – there might be a downside. DeZoort et al (2001) experimented, and their results indicated that external auditors would rely less on internal auditors and increase their budgeted number of hours.

and the American Institute of Certified Public Accountants (AICPA) held a conference, "Converging Roles: The New Relationship Between Internal and External Auditors", in Lake Buena Vista, Florida (November 8–9, 2003), to underline their common goals of emphasizing competence, independence, and objectivity and helping restore public trust. The Public Company Accounting Oversight Board (PCAOB) applauded the converging roles approach and acknowledged that public trust is a top priority.

Further, Professional Standards travel the globe - via professional programs, such as the Certified Internal Audit certificate - and affect the internal audit community. The IIA Inc.[52] has by March 2007 over 140,000 practitioners (with an annual growth rate of about 10% over the last three years) and about 64,000 Certified Internal Auditors (with a growth rate exceeding 10%). Undoubtedly, such developments will impact the convergence of ideas, beliefs and principles.

A final observation is that in all corporate governance codes[53] reference is made to the "COSO-model" as a best practice for internal control. The COSO report, first published in 1992 and with a sequel in 2003, has grown to be the global standard for risk and control issues in organizations. That in itself also creates a push for convergence thinking on this issue.

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[52] http://www.theiia.org/theiia/about-the-institute

[53] Combined Code in the UK, Tabaksblat in The Netherlands, Cromme in Germany, King in South-Africa, Sarbanes-Oxley in the US, just to name a few.

Chapter 4 Internal Audit: Theoretical Foundations

4.1 Introduction

It was argued in Chapter 2 that some solid grounding in theory would help rid the profession of some of this unwanted uncertainty. But what theory or theories? Naturally, it would be just what the doctor ordered if there were one or two suitable theories already available on the shelves, just waiting to fulfill our desires. Unfortunately, that is not the case. As was mentioned there, only a few attempts have been made to meet the challenge. Mautz and Sharaf (1961), Flint (1988), Wilschut (1994) who repeated the need for a "general auditing theory", and Kocks (2003). Up until now no one has picked up the baton. This Chapter inspects potentially suitable theories, and even if we can't use them whole and in their current form, perhaps we can scrounge together some bits and pieces that could be used in constructing a theory that might prove satisfactory in the future.

In other words, at least as far as theory is concerned, this thesis is very much preliminary spade work.

We will be focusing on Agency Theory and Transaction Cost Economics, because they seem promising. In Chapter 3 we learned that Corporate Governance has its origin in Agency Theory. A further review of the literature showed that when dealing with both a need for, and justification of, auditing in general the two theories were the most frequently cited. Further, they have been supported through numerous studies, as will be shown in the following sections. This chapter will start with New Institutional Economics as an umbrella term for a number of theories that are connected and intertwined. For example, contract theory and incentive theory. Some also call them New Organizational Theory. These theories all provide building blocks to understand the mechanics of how organizations are run.

In Section 3 Agency Theory will be discussed. In Section 4 Transaction Cost Economics. Section 5 will take a look at research based upon Agency Theory and Transaction Cost Economics and applied to internal auditing.

4.2 New Institutional Economics

New Institutional Economics was developed as a reaction against neoclassical theory. It contended that the latter focused too much on efficiently allocating resources and Pareto optimality. According to New Institutional Economics, some unrealistic neoclassical assumptions were:

- Efficiency and optimization problems can be solved independent of institutional variants.
- Its models are based on the assumption of perfect information and perfect foresight.
- All information is contained in relative prices, and they are the most important instrument for regulating markets.
- Transaction costs do not exist.
- The institution can be relegated to, and considered as, a black box.

The central tenet of New Institutional Economics is "institutions matter for economic performance". Let's now take a closer look at New Institutional Economics assumptions.

New Institutional Economics Assumptions

Furubotn and Richter (1998, 2-8) arranged the central assumptions of New Institutional Economics accordingly.

1. Methodological individualism: People are different and have different tastes, preferences, goals, intentions, and ideas. Therefore, it is necessary to analyze the behaviour of individuals to explain existing economic phenomena.

2. The Maximand: Individuals pursue their own interest and try to maximize their utility within institutional limits. All choices are based on the maximization of individual utility.

3. Individual rationality: There are two possible approaches - perfect or imperfect individual rationality.
   a) In the perfect variety it is assumed that decision-makers have stable preferences, which determine their behavioural choices.[54]
   b) In the imperfect those preferences are variable and not always known. (North, 1978, 972).

   The latter also assumes that transaction costs are unavoidable (Williamson, 1975, 1993, 1996). What's more, people are subject to "bounded rationality" (Simon, 1957), which makes it impossible to process all available information because much information is lacking and due to lack of processing skills. Kahnemann and Smith (2002) - the first a Nobel Prize winner in economics - have also shown that in many instances people do not behave rationally. They make decisions that they would not have done in a rational mood.

4. Opportunistic behaviour: Williamson[55] (1975) indicated that humans pursue their own interests and, therefore, tend to demonstrate opportunistic behaviour. If this is so, as he and Kreps (1990) contend, then people cannot be trusted[56] and, therefore, "complete contracts" cannot be written, let alone enforced.

5. Economic society: A society consisting of individuals who share a common set of norms and values, awards property rights, and can force these on each member of that society. Property rights give people the right to use objects and intellectual property, enjoy the advantages of these, and promote specific behaviour in others. These rights are transferable. The concept of property rights is necessary to understand the implications of running an organization (see Section 4.2.3). They are determined and guaranteed by governance structure.

[54] "A completely rational individual has the ability to foresee everything that might happen and to evaluate and optimally choose among available courses of action, all in the blink of an eye and at no cost." (Kreps, 1990b, 745).

[55] Williamson (1975, 48): "self-interest seeking with guile"

[56] It is important to note that the concept of trust has not been discussed in connection with this. Williamson considers trust irrelevant. But according to others, trust does indeed play a role (Nooteboom, 1999, 2000). "Trust is a slippery concept, but it can be rigorously defined, analyzed and tested empirically." (Nooteboom, 1999). The trust issue will be dealt with below.

5. Governance structure: Set up to run an organization, it is all about authority and making sure that decisions can and will be taken, and followed up on. Authority implies the power to make and enforce decisions, and applying sanctions when not complied with. By court order if necessary.

7. Institutions: It is not easy to define an institution.[57] Institutions are established primarily to guide the individual behaviour in specific directions, thereby decreasing uncertainty (North, 1990, 239). Institutions are the rules of the game without the players themselves, and their functioning is dependent on the individual usage. In Popper's view (1957, 66), this implies that: "You cannot construct foolproof institutions. Institutions are like fortresses. They must be well designed and properly manned".

8. Organizations: Are comprised of institutions plus people (North, 1990). Arrow (1970, 224) defines a formal organization as "a group of individuals seeking to achieve some common goals, or, in different language, to maximize an objective function". He therefore calls the problem of "organizational control" as order[58]. Since this does not happen automatically, resources are involved. The use and costs of these resources are called "transaction costs".

These New Institutional Economics assumptions show that it is not possible to foresee all possible conditions. Therefore, incomplete contracts[59] are the rule to which there are no exceptions. Under some conditions this creates the need for auditors and arbiters to assess the correctness of information provided and assess whether the terms of the contract have been met.

> The parties (to a contract) will quite rationally leave out many contingencies, taking the point of view that it is better to "wait and see what happens" than to try to cover a large number of individually unlikely eventualities. Less rationally, the parties will leave out other contingencies that they simply do not anticipate. Instead of writing very long-term contracts the parties will write limited-term contracts, with the intention of renegotiating these when they come to an end. (Hart, 1987, 753)

Given this incompleteness of contracts, enforcement is also conditional. Building in *ex ante* guarantees against *ex post* opportunism is desirable, but will lead to transaction costs (see below). It is important for internal auditors to understand the notions of "incomplete contracts" and "bounded rationality". We will address that further in Section 4.6.

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[57] Schmöller (1900, 61) came up with the following definition: "a partial order for community life which serves specific purposes and which has the capacity to undergo further evolution independently. It offers a firm basis for shaping social actions over long periods of time; as, for example, property, slavery, selfhood, marriage, guardianship, market system, coinage system, freedom of trade."

[58] This consists of a set of operating rules "instructing the members of the organization how to act" and a corresponding set of enforcement rules "to persuade or compel them to act in accordance with the operating rules".

[59] Much use of the word "contract" is metaphorical. Agreements do not necessarily have to be written to be contracts. An arrangement between two people to meet for dinner could be deemed a "contract".

How can New Institutional Economics be applied?

New Institutional Economics models institutions and economic behaviour. But how can New Institutional Economics be applied and to what extent? Williamson provided the following diagram (1998, 26 and 2000, 597):

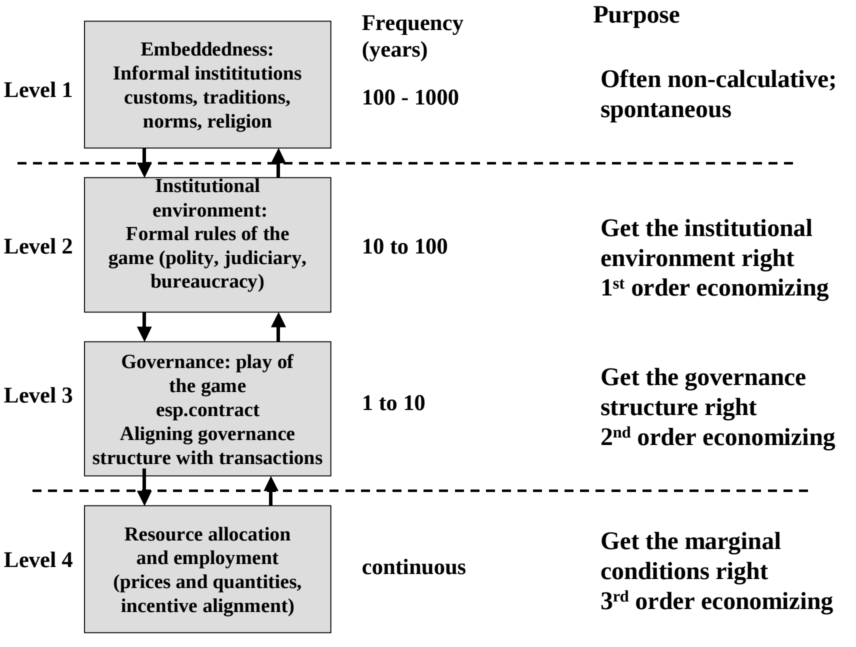

Figure 6: Applicability of New Institutional Economics

These levels are already explained in Chapter 1. According to Williamson, New Institutional Economics focuses on levels 3 and 4. Agency Theory and Transaction Cost Economics are theories that slot into New Institutional Economics. While New Institutional Economics sees the firm as a nexus of contracts (Furubotn and Richter, 1998, 152) though, Transaction Cost Economics sees it as a governance structure.

Property rights

The concept of property rights is essential for a good understanding of both Agency Theory and Transaction Cost Economics. According to Roman law, the most important characteristics[60] of (absolute) property rights are the rights to use physical goods (*ius utendi*), benefit from the revenues coming from those goods (*ius fruendi*), and the power to manage them and the possibility of alienation (*ius abutendi*). It is also possible to separate those rights: meaning that parts of the above can be alienated.

The way property rights are assigned within an organization influences optimization problems: not only the amount of transaction costs and efficiency, but also the distribution of

60 Furbotn, Richter, 1998, 77

income and power between contracting parties. Individuals will, therefore, try to set up their property rights in a way that maximizes gains from transactions. Thus when individuals are pursuing their own interests there is no guarantee that revenue maximization or cost minimization for the organization will be achieved[61].

Contract Theory

Since contracts are an important issue in both Agency Theory and Transaction Cost Economics, contract theory will be briefly discussed in this section. A contract is influenced by transaction costs in relationship with Information Asymmetry and transaction specific investments. This creates a mix of contractual and information problems[62] that need to be solved.

First, information can be incomplete at various stages of the contract. For instance, *ex ante*, before drafting the contract. Crucial information might be missing while executing the contract and even *ex post*, after having the contract has been completed. Further, one party might have the information, but is unwilling to share that with the other party or parties (Information Asymmetry). Or worse, some distortion and other forms of deceit might be afoot. Information that might not be favorable might be distorted to serve the interest of one party at the expense of the other (s) (moral hazard, opportunism). These problems are dealt with by what is called "incentive theory". How do we create the best incentives to overcome Information Asymmetry and moral hazard or opportunism?

Second, even if there is a lack of critical information, one could still try to deal with that problem. The easiest solution to the problem is avoidance. Price mechanisms, proverbial economic wisdom has it, are one way out. All information is in a way "embedded" in the price of goods. Thus one needn't bother about specifics and the costs involved. The price says it all. When purchasing a car all one has to do is compare prices, and *c'est ça*. But, surely, this solution is only viable in markets where prices are comparable. Unfortunately, there are many where that is not at all the case. That's when specific contracts need to be drafted and coordination costs need to be incurred.

There is also the problem of assigning property rights. This was already touched on in the section above. Contributors to this issue are Alchian (1969), Demsetz (1967), Klein, Crawford and Alchian (1978), and Furubotn and Pejovitch (1972).

Some subsets were developed within contract theory to deal with the above-mentioned problems.

1) Incentive Theory or Agency-contract theory
2) Incomplete Contract Theory
3) Transaction Cost Theory

[61] The famous example of the problem of the commons whereby a community has a meadow and the issue is from a maximization of outputs point of view, whether it is better to make it community owned or split up the meadow in small privately owned parts. The solution is that the latter is preferred since every individual within the community will add sheep or cows to the meadow as long as his incremental outputs will be positive although this might decrease the output of the meadow as a whole. This is one of the explanations why any communist or socialist system will fall short compared to the capitalist system.

[62] See Brousseau and Glachant (2001) for an overview.

Incentive theory

Information Asymmetry[63] leads to adverse selection *ex ante* - the less informed party is inherently disadvantaged - and moral hazard *ex post*. It is expected that the more informed party will act in his own best interests, and if possible and necessary, to cheat to reach his objectives. Especially when he deliberately withholds important information. Therefore, contracts are designed in such a way that agents are stimulated to behave according to the best interest of principals. The focus is on reward and incentive systems. How do we as principals "guide" agents in the direction we want them to go? This is also of interest for internal auditors. They need to be aware that reward and incentive systems will be used to influence their behaviour and that it drives the efforts of agents. This will focus their efforts on assessing the adequacy of information and behaviour in the context of a contract.

Incomplete contract theory

If it is impossible to determine whether contractual obligations have been lived up to, the issue of contract fulfillment becomes yet another negotiation. Because of this, contracts often contain a clause giving one of the parties the right to determine *ex post* what the actual achievements were and the other party the right to dissolve the contract if he does not agree (Telser, 1980). The focus is on clauses necessary for arranging renegotiations and default. Such contracts, which are called self-enforcing (Frank, 1992), and are used in situations where the possibilities of inspecting for contract fulfillment are more than usually limited. In such cases, obviously, the opportunities for legal redress are nil.

Transaction cost theory

The assumptions are the same as in incomplete contract theory. In these cases the contract allocates decision rights to one party, both parties (negotiation), or a third party (judge). The latter may seem a sound idea. But since courts do not have the proper knowledge, expertise and skills to absorb all the information (bounded rationality) their ability to assess the achievements of the contract is limited. Supervision and coercion are then the mechanisms. Williamson speaks of private ordering. In situations of private ordering internal auditors of both parties could make important contributions to the process.

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63 Information Asymmetry is an often used term within Agency Theory. It describes a state in which someone has more information than someone else. In this case the agent more than the principal. In the literature, Information Asymmetry is almost always dealt with as the asymmetry of information between insiders (company officers) and outsiders (analysts, shareholders, regulators, etc.). This "external" Information Asymmetry has been widely researched by many. This Asymmetry is measured by such proxies as R&D expenditures and spreads between bid offers. By contrast, "internal" Information Asymmetry - say, between top and lower management - has scarcely been dealt with. One exception to the trend is a study by Jaworski and Young (1992) among marketing managers. They measured Information Asymmetry by asking marketers to assess on a scale of 1 to 5: how well they knew what was expected of them; how familiar they were with their tasks; how much knowledge and understanding they had of their jobs; and whether they knew the performance objectives and the most important variables to monitor. They were also asked how they thought their bosses would answer the same questions. The author concluded that: "more work needs to be done to refine the measures of information asymmetries" (1992, 31). Their questions were used – in an adjusted format - in the survey described in Chapter 6.

4.3 Agency Theory

Agency Theory is based on two essential actors: a principal and his agent. In its simplest form the principal wants to know whether the agent is acting in the best interests of the principal. Or, and not at all necessarily the same, the best interests of the agent. As a somewhat free and self interested individual, however, the agent will almost by definition have another agenda. He can shirk (free riding) or misstate what he is doing and the results of that behaviour. In either case, the principal needs to "monitor" the (reported) outcome (hidden information) or the behaviour (hidden action) of the agent. Or both. Surely, if the agent was able to do that and satisfy everyone's needs, it wouldn't be necessary to have someone else do the job. Unfortunately - or *ç'est la vie* - that is generally not the case. Especially in a large organization. Therefore, the principal needs a third party for the monitoring task.

Agency Theory operates at level 4 - 3rd order economizing (see Figure 5 above) - and deals with the problems of marginal conditions. In this section the focus will be on Agency Theory's contributions in determining incentives to influence the behaviour of agents in such a way that their performance is as efficient as possible and meets to the max the interests of the principal.

Agency Theory deals with situations that are quite common when principals and agents sign contracts with each other. The principal cannot observe the actions of the agent (hidden action; Arrow, 1985b, 38), and/or the agent has information the principal doesn't (hidden information). The terms "hidden action" and "hidden information" originate in the concept of "moral hazard" (insurance theory). Moral hazard can be described as an *ex post* situation of Information Asymmetry, because the agent knows more than the principal. In cases where results are visible the amount of Information Asymmetry can be assessed. But there are huge areas where assessment is not an option.

> Stockholders are principals, who certainly cannot observe in detail whether the management, their agent, is making appropriate decisions. The principal-agent theory provides an instrument to discuss the rationale of the "separation of ownership and control" problem which Adam Smith (1776) focused on and which Berle and Means (1932) popularized 157 years later. (Jensen and Meckling, 1976, 327)

Thus in principal-agent relationships a need for monitoring arises. In theory, of course, the principal himself can do the monitoring. But there are some fairly obvious reasons why that is not done. First, it would reduce the distinction between the principal and agent and, consequently, the need for an agent. Two, many principals do not wish to spend their time monitoring agents. Three, many principals are either partially or totally incapable of monitoring their agents. Thus, in many, if not all, cases, principals decide to hire a specialized monitor: an auditor. The scheme is complicated further because the monitor himself is an "economic agent" (Antle, 1982) who has a contract with the principal and may also be subject to shirking or misstating the results or his behaviour. Or both.

There are two variants in the Agency Theory (Jensen, 1983). First, a normative variant, which uses the achievements of micro economics and tries to create insights in optimizing problems via utility functions (constrained maximization). This theory is by nature predominantly mathematical and rarely empirically tested. Second, the positive variant, which focuses mainly on monitoring and bonding of contracts and organizations. This variant is predominantly non-mathematical and empirically tested. It tries to model the effects of the context in which contracts are designed and detect what organizational form has the most chances of survival.

Although the separation between the normative and the positive variant are not always that clear (Eisenhardt, 1989a)[64], attention will be paid to the positive variant, because of its wider applicability for theorizing about internal auditing.

Positive Agency Theory

Jensen and Meckling (1976) are the most important contributors to positive Agency Theory. According to them, the concept of agency costs is very important.

> The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions, which would harm the principal or insure that the principal will be compensated if he does take such actions…. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary). And in all there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. (1976, 308)

According to Jensen and Meckling, agency costs are the sum of:

- Monitoring costs (e.g., costs of external auditor)
- Bonding costs (costs agents incur to convince principals of their efforts; e.g., by having these efforts measured by internal auditors)
- So-called residual loss (total other costs that need to be incurred)

Even if it were cheaper to have the agent himself collect and verify information necessary for monitoring, it is still better to have a third party do it. This is driven by the need for independence and objectivity (see Chapter 2). According to Agency Theory, this is one of the reasons audit has a license to operate.

Agency problems within the organization are predominantly the consequence of a classical division of capital and labor, and ownership and control. Fama (1980) and Fama and Jensen (1983, 303) have questioned how decisions are made within organizations and distinguished four steps:

1. Initiation: ideas and initiatives are generated
2. Ratification: choices are made
3. Implementation
4. Monitoring: measuring results and acknowledging rewards

The first two steps are called decision management and the last two decision control. It is important to achieve the most efficient distribution between the first two and the latter two

[64] Eisenhardt (1989a, 60) stated that "the important point is that the two streams are complementary".

and the residual risks between the agents. This makes the organizational structure relevant. The question is whether these first three functions should remain in the hands of one agent. In "simple" organizations - law or consultancy firms - it is economically advantageous (more efficient) to combine them in the hands of one or a limited number of agents. Why? Because transferring the relevant and often extremely detailed information to others can be very expensive.

The question of separation of ownership and control is important for large organizations and, therefore, internal auditors. Fama and Jensen (1983) have said that in large organizations decision management and decision control should be separated. Especially when specific knowledge is necessary to reach a good decision it is wise to delegate those decisions to the level where the needed information is available. This will reduce information and agency costs. Decision control can then be delegated to those who also evaluate performance and may decide on appropriate remuneration. From an efficiency point of view, the number of residual claimants (residual risk bearers) - those authorized to decide what to do after all costs have been paid - should be limited. The residual claimant is the one who can dispose of what's left after all costs have been subtracted from revenues.

Alchian and Demsetz (1972), who studied incentive structures and residual claimants and analyzed team production, concluded that teams can do much more than individuals. But the downside of that is free riding, or shirking. That is, not all the members of the team carry their fair share of the weight. This then requires the appointment of a specialized monitor, who has the right to change the contract and distribute incentives (decision control). High performing team members can expect bonuses. Since opportunism on the side of the monitor might lead to biased numbers, this reported information might also be subjected to scrutiny by an auditor.

With regard to the capitalistic entrepreneurial form, Alchian and Demsetz (1972) also conclude that there should be one residual claimant, who is the central party to all contracts with inputs, entitled to observe behaviour and, if necessary, alter team membership. The latter is needed to ensure that when noticed shirking will be punished, and, therefore, increase team production. He also has the option to sell these rights.

Some Criticism of Positive Agency Theory

Criticisms of Positive Agency Theory are predominantly focused on its assumptions about human behaviour. Baker, Jensen and Murphy (1988) demonstrated that the relationship between performance and reward is not always straight forward and suggested that "a hierarchy that can induce the right kind of cooperation – defined as voluntary deviation from self-interest behaviour – will have an important competitive edge over other firms" (1988, 12). This leads us into the area of trust, which will be elaborated on later in this chapter.

Miller (1992) criticized the attitude of incentives being a cure all. According to him, using rewards and punishments to discipline individual behaviour is too mechanical. Using the work of Baker et al, he based his criticisms on the "prisoners' dilemma". That is, there are situations when following your limited self interests is not totally, or even partially, in your best interests. For example, in a leadership position in a modern organization, where conflicts are inevitable. It is in the best interest of the leader to put the interests of the group above his own. It is his task:

> to shape expectations among subordinates about cooperation among employees, and between employees and their hierarchical superiors. This is done through a set of activities that have been in the realm of politics rather than economics: communication, exhortation, and symbolic position taking. Most important perhaps, the leader has a central role in committing the organization to what is in effect the constitution of the hierarchy – the allocation of generally accepted responsibilities, rules of the game, and property rights that provide the long-run incentives for investment in the firm. (Miller, 1992, 217)

Miller (1992, 2) suggests that there are also other possible approaches, such as "leadership that is inspiring a willingness to cooperate and take risks, to innovate, to go beyond the level of effort that a narrow, self-interested analysis of incentives would summon". He is convinced that conflicts between individuals and group interests are the central characteristic of large modern organizations (1992, 236-7).

Positive Agency Theory has had some impact on the debate of mitigating agency problems via incentives and rewards. But there is also a serious debate about its adverse effects. What might be called "the negatives of positive Agency Theory". Jensen and Murphy (2004) thoroughly researched the remuneration issue, and their conclusion is worth pausing over.

> In their 1990 study of CEO compensation Jensen and Murphy (1990) had this to say: "Are current levels of CEO compensation high enough to attract the best and brightest individuals to careers in corporate management? The answer is, probably not." … As the reader of this report has undoubtedly surmised, Jensen and Murphy would not give that answer today. Indeed, we have emphasized here that while executive compensation can be a powerful tool for reducing the agency conflicts between managers and the firm, compensation can also be a substantial source of agency costs if it is not managed properly. And as we've summarized, there is substantial evidence that we can do much better in the future. (2004, 98)

The issue is of course that there may always be dysfunctional behaviour. One of which - called "earnings management" - has surfaced in spades inside the corporate scandals of Enron, WorldCom, Tyco, Adelphia, Ahold, Parmalat, and many others we know so well from reading the newspapers. Incentives, in the form of stock options, induced managers to "cook the books" to such high temperatures that a number of them boiled over and melted down. ‚A number of studies (Bruns and Merchant, 1990; Degeorge, Patel, and Zeckhauser, 1999) showed that "earnings management" has been around for a while. One (Bruns and Merchant, 1990) concluded that "we have no doubt that short-term earnings are being manipulated in many, if not all, companies".

4.4 Transaction Cost Economics

Transaction costs

Transactions are costly. Some call that the costs of running the economic system (Arrow, 1969, 48). Some estimate that up to 50-60% of the US Net National Product consists of transaction costs (Furubotn, Richter, 1998, 39). Therefore, it is necessary to be as efficient as possible in order to be able to economize. Williamson (1985, 1) defines a transaction as:

A transaction occurs when a good or service is transferred across a technologically separable interface. One stage of activity terminates and another begins.

In an ideal world, there would be a perfect market in which all transactions take place and all information would be conveyed in the price of the good or the service rendered. Then one only needs to survey the market and make a selection. Unfortunately, that is not at all how things work. Many goods are not available on the market. They need to be manufactured according to specific requirements of the buyer. Goods and services are in many cases neither homogeneous nor transparent.

In order to conclude any transaction a number of activities need to be undertaken. For example, searching for parties to contract with, collecting information, performing negotiations, drafting contracts, and monitoring the adherence of contractual and other obligations. In all circumstances we need to take into account the assumptions promulgated by New Institutional Economics, such as bounded rationality and opportunism, which increase problems of collecting information, performing negotiations, etc. and create vast amounts of difficulties. At the end of the day this will lead to incomplete contracts.

Governance Structures

Organizations allow for specialization and have to incur costs for drafting contracts with employees, buyers, suppliers and the like. Coase (1937) researched why there are organizations in different shapes, forms and sizes. He founded Transaction Cost Economics and concluded that organizations compete in many ways, one of them being the ability to economize on transaction costs. The basic scheme of market versus organizations (the hierarchy) needed to be adjusted, because there are many variations - called "hybrid[65]" - falling in the chasm between the two. For example, joint ventures and alliances. Williamson (1975) calls them governance structures. Governance structures need to be judged on their shortcomings in answering and limiting the *ex post* risks of opportunism by an *ex ante* choice of governance structure (Williamson, 1996, 14).

Market governance is the simplest form, because it is based on free market competition. Spot contracts and long(er) term contracts are closed and adaptation is worked out by negotiating a new contract as soon as the former expires. Price is the single mechanism for absorbing all information and one needs to know nothing else to make the right choices.

Hierarchy governance uses contracts with explicit clauses concerning the desired outcomes. If conditions call for it, such contracts are characterized by high flexibility concerning the scope and timing of necessary adjustments. Labor contracts use fixed compensations with little space for performance-dependent rewards. In the long term promotions are used that create an indirect relation between performance and reward. Further, competent representatives decide who can make which decisions. Conflicts are resolved internally, sometimes using internal judges or arbitrators, thereby following a "doctrine of forbearance", according to Williamson (1996, 97-100). Monitoring, the design and the maintenance of the internal reward systems involve substantial costs.

The hybrid variation uses extensive contracts with clauses about necessary or desired adaptations based on changes through its duration. While the contracts are extensive about all

[65] It is acknowledged in research that many need to be categorized as "hybrid" ("the swollen middle", Hennart, 1993).

sorts of contingencies, they are not complete. Adjustments are mostly made by mutual consent. They involve transaction specific investments and, therefore, both parties will demand guarantees. This often has the form of "hostages", in which one party, by means of correction, is rewarded for possible asymmetric rewards of the other. When differences between the parties become irreconcilable, they can choose to go to court, but only when sufficient information is available. When it isn't, arbitration is a more plausible adjuster.

Since economizing on transaction costs is the central theme of Transaction Cost Economics, it is especially important to be aware of the need to adapt to changing circumstances. Given the certainty of uncertainty, bounded rationality, and incomplete contracts, the unexpected is to be expected. Both adaptation and the lack thereof - what Williamson (1996, 16) calls "maladaptation hazard" - are important themes for every organization.

Normally, adjusting, adapting coordinating takes place through sets of rules and instructions. Williamson (1975; 1996, 59) identified three critical attributes that determine governance structure, because they facilitate, or hinder, economizing on transaction costs. They are Asset Specificity, uncertainty/complexity, and frequency. Asset Specificity happens when transactions are characterized by investments that have little or no alternative use. Thus in the event of contract breaches and terminations, there will be substantial losses. It can consist of location, physical assets and human capital (specific knowledge and capabilities).

All these attributes impact the drafting of any contract. Asset Specificity increases the risks of the contract – at least for the one investing in the assets – and the more specific the assets to the contract are the more incomplete the information for the *ex ante* decision making will be and, subsequently, the ex post checks of the fulfillment of the contractual obligations.

Uncertainty/complexity of the environment or the conditions increases the problems as does frequency. If frequency increases, so does the number of transactions and risks. From the perspective of economics Asset Specificity is the most important factor determining the most optimal governance structure.

Asset Specificity and opportunism together determine when and why successful adaptation is unlikely. The higher the Asset Specificity the more problematic it will be to include all variables in the contract. Because of opportunism, a cooperative attitude cannot be assumed. The higher the Asset Specificity the larger this risk becomes. As Asset Specificity increases so does mutual dependence. In a way this is a classic "Mexican standoff" and further complicates contracting and makes full coverage even more impossible.

The final choice between the three basic governance variants: market, hierarchy, or hybrid, is dependent on the degree to which contracting parties succeed in reaching alignment and contribute to economizing on transaction costs. Williamson (1975) considers these a "trichotomy". In other words, a scale in which distinctive variants can be identified, each with their own characteristics and, therefore, not fitting into a continuum.

Make or Buy: Limits of Integration

"Make or buy" decisions are the classic problem for which Transaction Cost Economics is used. This issue is described in many ways. The central theme is whether it is feasible to integrate crucial steps in the production process into the organization. This is called "vertical integration". But there are limits to what can be absorbed and integrated. If that wasn't the case, there would be only one organization ruling the world.

What factors limit the size of an organization? When an organization is capable of replicating the characteristics of market success and preventing those of failure (selective intervention) the organization is perfect and, conceivably, could keep on growing. But this is not possible. Let us take a closer look at this subject.

As already mentioned, markets are frequently unavailable. The hierarchy or organization is an option when markets fails (Williamson, 1971, 114). Coase (1988) questioned why all transactions don't go through the market and why organizations exist.

> The solution to the puzzle was, as it turned out, very simple. All that was needed was to recognize that there were costs of carrying out market transactions and to incorporate them into the analysis, something that economists have failed to do. A firm had therefore a role to play in the economic system if it were possible for the transaction to be organized within the firm at less cost than would be incurred if the same transactions were carried out through the market. (1988a, 19)

Coase then spoke of the make or buy decision. Organizations expand until the costs of extra transactions are equal to the costs of that same transactions through the market (1937, 395). The assumption is that markets prevails because, normally, they have lower transaction costs. Coase (1991, 59) described this as follows:

> There is, however, one misunderstanding that, I fear, is both widespread and serious, one that relates to the very heart of my thesis. This concerns the source of the gains, which accrue through the existence of the firm. My view is, of course, that they come from a reduction in transaction costs. But the main transaction costs that are saved are those, which could otherwise have been incurred in market transactions between the factors now cooperating within the firm. It is the comparison of these costs with those that would have to be incurred to operate a firm which determines whether it would be profitable to establish a firm.

Williamson gave three advantages for internalizing transactions within the organization:

> First, in relation to autonomous contractors, the parties to an internal exchange are less able to appropriate subgroup gains, at the expense of the overall organization (system), as a result of opportunistic representations…. Second, and related, internal organization *can be more effectively audited* [emphasis mine]. Finally, when differences do arise, internal organization realizes an advantage over market mediated exchange in dispute settling respects. (1975, 29)

Grossman and Hart (1986) stated that there are also limits to the integration from the perspective of incentives. They considered property rights and incentives to be interrelated. It's impossible to change property rights without changing the incentive structure. Maintaining the same incentive structure within the organization as outside is very costly and, therefore, not always possible.

> High powered incentives provided by markets cannot be duplicated by firms without substantial added costs. (Furbotn and Richter, 1998, 337)

And:

> Vertical integration is the purchase of the assets of a supplier (or a purchaser) for the purpose of acquiring the residual rights of control…. That is, integration shifts the incentives for opportunistic behaviour, but it does not remove these incentives. (Grossman and Hart, 1986, 716)

Williamson indicated that a former owner who is now the manager will tend to manage *myopically*, because it is now in his best interests to strive for direct proceeds and leave the costs for maintenance and such to his successors. Your headache, not mine. Williamson added:

The core arguments are these: (1) internal organization (the large firm) cannot replicate small firms (market procurement) in incentive intensity respects, and (2) the agreement to always intervene but only for the good cause (selective intervention) is fatuous because it is unenforceable. The upshot is that the hypothetical advantages of combining replication with selective intervention cannot be realized, on which account the move from market to hierarchy (and the reverse) is always attended with a trade-off between the benefits of added coordination/cooperation on the one hand and the costs of added bureaucracy on the other. (Williamson, 1998, 44)

Kreps (1990) also pointed at limits to integration. He indicated that because of growth there will be more contingencies and *ex post* difficulties in evaluating whether contracts are fulfilled and, therefore, it will become more difficult to control the organization. The reputation of an organization can be an important enforcement instrument, though only when it is clear what is promised and what can be expected and when it is possible to observe if someone is, or is not, meeting his obligations. The problem is that especially with relational contracts it is impossible to specify beforehand what is promised and what can be expected.

The bigger the organization the bigger this problem, which causes further loss of control. Kreps (1990, 130) connects reputation with corporate culture. Corporate culture is a way of showing employees how their interests are being dealt with. However, Williamson (1996, 153-154) denies that reputation is a strong enforcing instrument.

Milgrom and Roberts (1988) indicated that large organizations are characterized by the fact that authority and autonomy are more than usually concentrated at the top. The risk of power abuse increases and managers tend to unnecessarily interfere with operations and businesses. This is known as "exercising influence" and the costs of doing it are, not surprisingly, described as "influence costs".

> These include (1) a tendency for the authority to intervene excessively, both because intervening is that authority's job and because the authority may have a personal interest … in certain decisions; (2) increased time devoted to influence activities and corresponding reduction in organizational productivity, as interested parties seek to have the authority intervene in particular ways or to adopt their favored alternatives; (3) poorer decision making resulting from the distortion of information associated with influence activities; and (4) a loss of efficiency as the organization adapts its structure and policies to control influence activities and their costs. (Milgrom and Roberts, 1990, 89)

Williamson (1996, 17) indicated that the increasing costs of bureaucracy is a barrier to the growth of organizations. He (1985, 141 and 142) also pointed at the concept of "causal ambiguity". When a division is responsible for the success of research, but encounters obstacles sharing their findings with other divisions because of organizational structure, the supplier might have less motivation than if they had a direct interest in profiting from innovations. He also noticed that even if causal ambiguity can be prevented "general office intrusion" can't. Given the separation of power within the organization, "a re-distribution away from operating parts in favour of the ownership is apt to be effected by manipulation of the transfer pricing and cost accounting rules".

Causal ambiguity and general office intrusion are wonderful phrases, which in plain English translate as every man for himself.

Criticism of Transaction Cost Economics

Three areas of critique are briefly discussed: the definition of transaction costs, the assumption of bounded rationality, and the notion of opportunism and trust.

Definition of transaction costs

One of the most fundamental objections against Transaction Cost Economics is the poorly defined transaction costs. Goldberg (1985, 398-400) wrote:

> My hostility to transaction costs must strike readers as odd, since the "new institutional economics" and "transaction cost economics" are often thought of as synonymous …. As far as the economic actors are concerned, transaction costs are the same as other costs. The transaction costs are an unobservable residual; they are the opportunity cost of the world not being as nice a place as it otherwise might be. In this formulation, the transaction cost label is a redundancy.

Perrow (1981, 375) wrote:

> Any compelling analysis can be reinterpreted by saying that X or Y is really a transaction cost.

The costs of maladaptation are also particularly difficult to define. This is more than mildly inconvenient, because Williamson defined adaptation as the central theme of Transaction Cost Economics.

While Whyte (1994) did not deny the relation between Asset Specificity and vertical integration, he thought the determining factor for that preference was "sunk costs" that developed as a result of Asset Specificity.

Bounded rationality

Much criticism of Transaction Cost Economics, like Agency Theory, has focused on its behavioural assumptions. One of those is bounded rationality. Many critics were not prepared to admit either its existence or, if it did exist, its significance. Baiman (1990) reflected on the concept of bounded rationality and the concomitant circular reasoning. Dow (1987, 27) states: "if agents cannot cope with contracts featuring complex contingencies, it is doubtful that they can select in advance an efficient decision making procedure to use in adapting to future circumstances". But resistance is waning.

> In this survey [Dow's], four reasons are given for incorporating bounded rationality in economic models. First, there is abundant empirical evidence that it is important. Second, models of bounded rationality have proved themselves in a wide range of impressive work. Third, the standard justifications for assuming unbounded rationality are unconvincing; their logic cuts both ways. Fourth, deliberation about an economic decision is a costly activity, and good economics requires that we entertain all costs. (Conlisk, 1996, 669)

Kahneman and Tverski's "prospect theory" (1979, 1996) provided sufficient starting points to demonstrate that bounded rationality is a significant phenomenon. They show that decision makers use heuristics and perceptions do play a role in decision making. Mental models for interpreting situations are important and the attitude of the decision maker influences the decision-making. The availability of data is also important. When data is directly available and visible a greater value is attached to it than justified. This could be called grasping at straws. People also have a loss aversion. The risk of losing weighs more heavily on them than the chance of winning. Other anomalies are:

> the propensity for people to take out expensive small-scale insurance when buying appliances; their willingness to drive to a distant store to save a few dollars on a small purchase, but reluctance to make the same trip for an equally large discount on an expensive item; their resistance to lowering consumption in response to bad news about lifetime income.[66]

Opportunism and Trust

The most important criticism seems to focus on the concept of opportunism. Williamson has a strong point of view on this subject.

> The general effect of presuming the absence of opportunism is that we enter the world of what Frank and Fritzie Manuel describe as "utopian fantasies". (Williamson, 1999, 1099)

By the way, opportunism is worse than self-interest. It goes further because it assumes that lying and cheating for the benefit of one's own interests will be the starting point.

Nooteboom (2000) puts forward the concept of trust as a natural counterweight to opportunism.

> The preoccupation with opportunism, and the neglect or even rejection of the notion of trust, is misguided and theoretically inconsistent.… The passage of time is critical in transaction cost economics. (Nooteboom, 2000, 104)

The passage of time will provide both parties insights into the degree of opportunism that the other is engaging in. In other words, opportunism "will come out in the wash". Nooteboom also argued that if one party believes that because he is being monitored and, therefore, not trusted,

[66] Foundations of Behavioral and Experimental Economics: Daniel Kahneman and Vernon Smith, The Royal Swedish Academy of Sciences; Advanced information on the Prize in Economic Science 2002, 17 December 2002.

the other party will then assume that he is also not trusted and start behaving opportunistically. And everyone knows that this creates vicious circles. Frey (1993) described this argument as the "crowding out" effect.

Ghoshal and Moran (1996) also urged limiting the inclination to use Transaction Cost Economics's opportunism as the norm. They based their critique on the fact that Williamson did not distinguish between attitude and behaviour. While opportunism might be an inherent characteristic of human behaviour and an ongoing attitude, it is not necessarily an ongoing activity. That is, while people may constantly dream of taking the money and running, they don't actually do it. Opportunism can in that respect be an attitude or a demonstrated behaviour. For the analysis this separation would make a difference. They question if opportunism could also be a variable and, therefore, developed a model in which this is made endogenous.

They also refer to Ouchi (1980), who introduced the concept of clan control forming a last resort as a mean of control based on creating and sustaining a certain culture that will drive behaviour. The assumption of Ghoshal and Moran is that social/clan control can influence behaviour without changing the attitude of individuals (1996, 25). The clan control situation would be a situation in which the environment is constructed in such a way that there is no perceived threat of opportunism, even not for opportunists.

That situation is hardly ever the case and thus not likely to form a very solid base for making generalizations about anything. Therefore, other controls need to be used. Based on their model, in which opportunism is a variable, they argue that guarantees preventing unwanted behaviour need to be rooted in rational controls, which create situations that compel compliance.

Goshal and Moran (1996), and Hill (1990), believe that the organization is more capable of adapting to the unexpected than the market and that efficiency will be reached earlier. They point at two previously mentioned ways of adaptation: the autonomous, based on Hayek (1945), and the purposive (Williamson calls this "coordination adaptation").

> In his preoccupation with opportunism, Williamson did not consider that coordination can merely be a more efficient means for allocating resources, especially when prices, or even markets, are not available, and autonomous adaptation is difficult. (Ghoshal and Moran, 1996, 34)

The purposiveness is served with cooperation, which is consistent with Williamson's point of view. According to Hill (1990), this mechanism is comparable to price mechanisms in markets. Poppo and Zenger (2002) have a similar idea. They consider that formal contracts undermine trust and, therefore, promote opportunistic behaviour. They developed a model in which relational contracts and formal contracts are considered complementary and tested this using a survey. They showed that this indeed seems to be the case. They integrated trust as an endogenous element.

> Trust is a peculiar belief predicated not on evidence but on the lack of contrary evidence – a feature which makes it vulnerable to deliberate destruction. In contrast, deep distrust is very difficult to invalidate through experience…. Once distrust has set in it soon becomes impossible to know if it was ever in fact justified, for it has the capacity to become self-fulfilling, to generate a reality consistent with itself. It then becomes individually "rational" to behave accordingly…. Only accident or a third

> party may set up the right kind of "experiment" to prove distrust unfounded. (Gambetta, 1988, 234)

The existence of trust thus seems not easy to be measured, let alone proved. Even Nooteboom – a true believer in trust - (1999) notes that there is a problem.

> Trust is a governance device, in the sense that it helps to reduce transaction costs, and has the advantage of low cost and flexibility due to lesser need of detailed contracts. However, it cannot be purchased and installed at will…. But indeed: trust should not be blind, because there are limits to trustworthiness. (Nooteboom, 10, 13)

This leads to a dead end. If it's not possible to use trust at will - to turn it on at the push of a button - it immediately loses its value as a governance instrument. All other Transaction Cost Economics instruments can be turned on and off and, therefore, have a higher practical value than trust. Thus it seems that trust is not an instrument, but the result of many factors, some calculable, others not. Understanding what contributes to it and what diminishes it - through experience not only with one particular party, but many - can prevent the self-fulfilling prophecies of distrust mentioned by Ghoshal and Moran. To some extent, Nooteboom, Berger, and Noorderhaven (1997) agreed with this.

> Trust can only be considered an instrument of governance in a limited sense: it contributes to risk reduction, but it cannot be instituted instantaneously. (Nooteboom, Berger, and Noorderhaven, 1997, 318)

Casadesus-Masanell (2002) also concluded that trust is more a result than an instrument. He indicates that legal penalties and existing norms and values in the social exchange can lead to information being shared (more) completely, thereby eliminating moral hazard and adverse selection.

Williamson (1996) always responded to this criticism by indicating that he does not assume that opportunism is always present. Opportunism is a "reasonable" option that needs to be seriously taken into account. Nooteboom (1999) stated that if this opportunism is assumed variation among individuals will exist. He then does not understand that Transaction Cost Economics does not wish to take this variation into account. It could make sense if trust were declared a variable in choosing the most optimal governance form. According to Speklé, this is not the case.

> Unless the opponents come up with a rival explanation for these phenomena – which they have not done so far - the assumption of opportunism cannot be dismissed. And as for the supposed immorality of the assumption, one may of course not like people to behave opportunistically, but that does not change the apparent fact that they often do so behave. If one purports to build positive theories, one cannot bluntly ignore reality, no matter how unpleasant its manifestation. Moreover, the mere act of assuming opportunism does not imply some kind of value judgment. Rather, Transaction Cost Economics is amoral: right or wrong, opportunism simply is. (Speklé, 2001b, 37)

Thus even though these criticisms have some validity, that does not diminish the fact that Transaction Cost Economics has a great deal of explanatory power. That is, a great deal of empirical observations can be better grasped and understood using it (Shelanski and Klein, 1995, 2). "Taken as a whole, the body of empirical research in Transaction Cost Economics shows that a good deal of economic activity aligns with transactions in the manner predicted by theory." (1995, 352) Joskow (1991, 47) adds to this: "the growing body of empirical work in transaction cost economics is in many ways in much better shape than much of the empirical work in industrial organization generally."

4.5 Agency Theory, Transaction Cost Economics and Internal Audit

4.5.1 Introduction

From the perspective of this thesis a number of preliminary conclusions might be drawn. Both Agency Theory and Transaction Cost Economics provide evidence that auditing is a worthwhile undertaking, both as a bonding and as a monitoring device. The concept of Information Asymmetry is one of the explanations for the rationale for audit and may provide some clues with respect to the kinds and amount of audit required. Therefore, there might be a correlation between the level of Information Asymmetry and the size of an IAF.

Agency Theory focuses heavily on incentives and rewards as a means of aligning the interests of both principal and agent. Therefore, there might be a need to take those into account. This need may be enhanced due to such behavioural assumptions as opportunism and moral hazard, whereby the agent might try to present information and actions that serve his needs. Consequently, the principal will need to use an auditor to monitor and assess the reliability of the information provided. That is, if he is not in the position to monitor it himself. Management within the organization also suffers from this Information Asymmetry about lower level managers and will have a similar need. With regard to the issue of the auditor as an economic agent, he will need to be rewarded in a way that aligns the interests of both the principal(s) and himself. There might be an additional need to monitor the monitor in order to prevent "shirking", moral hazard and deliberate distortions of information. If an auditor is to give an opinion about information provided by another agent then it would be best not to be in a position where that agent is the auditor's principal. That is, his boss.

The importance of incentive and reward structures, reliance on information and metric and behavioural constraints and assumptions would surely create a need to assess the data and the process and systems in place that account for those incentives and rewards. Recent research on such corporate scandals as Enron, Ahold, Tyco, WorldCom (Jensen, Murphy, 2004; O'Connor, 2002, 2004; Partnoy, 2003) and corporate governance initiatives (see Chapter 3) show that it is almost mandatory that incentives and rewards will be closely monitored. The analysis of these authors showed that incentive schemes led top management to "cook the books" and that this needs to be monitored more closely.

The US' Sarbanes-Oxley (2002) was drafted in the aftermath of the corporate scandals and requires a number of participants to scrutinize the financial accounting processes in companies under review of the SEC. The main participants are Board members, Audit Committee members, and External Auditors as well as Internal Auditors (see also Chapter 3). The main objective of Sarbanes Oxley is to restore public trust and focus on the improvement of checks and balances that proved to be flawed in many of the corporations involved in the corporate scams. As contended by the research of Jensen and Murphy (2004), many of scandals may be related to the excessive use of incentive and rewards schemes. Their 38 recommendations to remediate were also geared towards rebalancing the inappropriate use of those very incentive and reward schemes.

All of the corporate governance codes and related rules and regulations use Agency Theory as a stepping stone. Since Agency Theory itself is geared towards maximizing efforts of agents via the use of incentives and rewards, it may not be too far off to consider the use of the External and/or Internal Auditors to review the use of those systems in their organizations. It will be interesting to see whether the Scope of Services of the IA has been affected by the corporate governance codes that were imposed on companies during the last decade. This question will be addressed in Chapters 5 and 6.

Transaction Cost Economics in general and Asset Specificity in particular might be useful to keep in mind when considering IA's role and rationale and size. The greater the Asset Specificity the more need there will be to assess the conditions of any contract and the degree to which it has, or has not, been met. And, subsequently, the greater the need for audits. This is also influenced by the level of Information Asymmetry and behavioural assumptions of Transaction Cost Economics. The more problematic it is to draft an *ex ante* contract the more necessary it will become to assess its performance.

Transaction Cost Economics deals with governance structure and might be helpful while addressing the make or buy issue for internal audit. On the one hand, one might expect that where Agency Theory has a compelling argument to make the internal auditor as independent as possible of other agents in the pecking order, thereby creating a need to come to a buy decision and hire a third party. Transaction Cost Economics would provide arguments for the make decision since an internally positioned internal audit would have best access to internal information and the required knowledge to be able to audit is highly Asset specific that buying the service might be difficult.

There is a distinct shortage of articles and research in which Agency Theory and Transaction Cost Economics are applied to IA. A study by Spaakman (1997) revealed that in comparison with external audit the academic literature on internal audit is limited. Boyle (1993) researched 6 journals (between 1975 and 1990) and found only 21 articles. Vinten (1996, 99-100) studied other journals and found some more. But his conclusions were not significantly different from Boyle's. From the academic perspective, Internal Audit isn't very thoroughly researched (see also Allegrini et al, 2006). In this thesis we surveyed 30 journals over an 11 year period (January 1994 till April 2005) and found 204 articles (see Appendix 2). About 76% of those (155) were published in just one journal *Managerial Auditing Journal*, leaving the grand total for the other 29 at no more then 49. Of those 29, 2 journals, *International Journal of Auditing* (containing 19) and *Maandblad voor Accountancy en Bedrijfseconomie* (MAB, a Dutch journal), had 19 and 10, respectively. Considering that only journals focusing on auditing were included, this is a paltry, even pathetic, total.

In the following sections the findings of research using Agency Theory and Transaction Cost Economics are applied to explore IA's role (and rationale), position, and Scope of Services.

4.5.2 Role

In this section we use the insights provided by Agency Theory and Transaction Cost Economics to further explain IA's role and rationale. Special Attention is paid to the make or buy issue.

The role and rationale of internal audit

As was shown in section 4.2.1 incomplete contracts are the norm. This implies that there is a need for audit services. However, that is hardly the end of the problem. Because it is asking too much to ask an auditor to solve problems that are in theory insolvable. The best any auditor can do is to unravel and reveal any information that may shed light on the terms of the contract, and provide assurance about its correctness.

Beyond that it is difficult to arrive at what is needed to provide the required assurance. Auditors need a soll (should) to compare the ist (is) with and conclude whether or not the information is correct. If contracts are incomplete, where is this soll supposed to come from? There needs to be at least an agreement about what soll all parties should use. This causes an impasse of sorts, because if the parties could get that far, there might be little reason for calling on an auditor.

Nevertheless, both Agency Theory and Transaction Cost Economics consider internal audit to be either a kind of monitoring (from the perspective of the principal) or a kind of bonding (from the perspective of the agent). In an organization structured according to the two-tier system, the Supervisory Board has the primary monitoring responsibility. It is appointed to act on behalf of shareholders (principals) to supervise the Management Board. Surely, the Management Board needs to monitor their subordinates as well. This is done by monitoring functions. IA is one of them. Agency Theory considers internal audit is supposed to monitor costs incurred to demonstrate that the agent is serious in serving the principal's interests. This helps securing the agent's position and salary. Wallace (1988, 125) argues that the principal's costs for monitoring the agent should be reflected in the wages paid. It is in the interest of the agent to perform audits, like the internal audit, to reduce the risk that the principal takes negative decisions about his compensation. There is, therefore, an "incentive" to have IA, even if that is just for securing his compensation. Agency Theory shows that the principal attempts to mitigate Information Asymmetry by increasing the level of certainty by requiring assurance. Supervisory Boards appoint external auditors to certify the financial information (in most cases the annual report).

Adams (1994) also said that agents gain if they can convince the principal that they are working hard in his - the principal's - interests. It is even important to safeguard their salary. This is consistent with the results of Holmström (1979), who implied that in cases of teamwork, the team-members benefit from a monitor (in this case the principal) who can ascertain their salary and change the contract.

Adams questioned why some companies have IA while others do not. He assumed that more complex organizations are more likely to have it than the less complex. Studies by Widener and Selto (1999), Kofman and Lawarrée (1993) seemed to corroborate that view. Those studies will be discussed later.

Why do the work approach and scope of internal auditors differ between organizations? His assumption is that internal auditors in stock-exchange listed organizations are focused more on financial, fraud, and compliance audits. This is consistent with the fact that ownership and control are separated, as shown above.

Spaakman (1997) noticed that one of the reasons for the lack of more sustainable research results about IA might be that Transaction Cost Economics is not used enough as a research terrain. Using Transaction Cost Economics, he conducted an experiment to test IA's usefulness in reducing transaction costs. Williamson (1975, 1985) said that internal auditors provide managers with information that is more useful in economizing than external auditors, because their reports include more than just straight financial numbers. Spaakman indicated that internal audit is especially suitable to reduce opportunism and maladaptation (in cases of dedicated assets) because in these cases internally verified information is necessary. Internal audit can also be important in situations of external uncertainty and a high frequency. According to Spaakman, managers obtain two advantages from the use of internal audit results. One, identification of deficiencies in the system of internal control. Two, a description of the control system. Therefore, if the audit results are objective, those from IA are more useful for economizing than external auditors.

Williamson (1975, 1985) provided several advantages of internal audit with regard to acquiring information. First, internal audit does not need to adhere to General Accepted Auditing Standards (GAAS) to determine if the Generally Accepted Accounting Principles (GAAP) are adhered to. Presumably, they have more options to retrieve crucial information. But this is unconvincing, because internal auditors also have standards (IIA Professional Standards) to comply with.

Second, since they are colleagues and the relationship is long-term, they can count on more cooperation from the employees within the organization.

> The auditing advantage of internal organization in relation to inter-firm organization is attributable to constitutional and incentive differences which operate in favor of the internal mode. An external auditor is typically constrained to review written records and documents and in other respects restrict the scope of his investigation to clearly pertinent matters. An internal auditor, by contrast, has greater freedom of action, both to include less formal evidence and to explore the byways into which his investigation leads. (Williamson, 1975, 29-30)

In 1985 he added:

> inter-firm auditing cannot be presumed to be as effective as intra-firm auditing.... internal auditors can expect to receive greater cooperation, including even hints as to where the "dead bodies lie", than can be presumed when auditing across an autonomous boundary is attempted. (Williamson, 1985, 154-155)

Penno (1990) contends that it is true that internal audit is able:

> to produce near first-best solutions in a principal-agent model with very simple contracts that use a small fraction of all available information. The attainment of such efficiency, however, depends on the level of management to which the internal auditors report. If independence is lost the ability of the internal audit function to

> provide information for incentives is impaired and the firm must resort to other sources of contracting information, such as its financial reports. Because … the information attested by the external auditor is more limited than that attested to by the internal auditors, first-best solutions may no longer be possible. (1990, 521)

From the perspective of auditing for performance evaluation purposes, that is an important conclusion, and may contribute to the contention that it might be worthwhile including performance evaluation data in IA's Scope of Services! Further, Penno corroborates the notion and importance of independence, although he did not elaborate any further.

Spaakman (1997) hypothesized that the usefulness of internal audit results for economizing varies with the degree of Asset Specificity, uncertainty, Scope of Services, and the level in the pecking order IA reports to. Evidence for this could also be found in a number of studies, especially that of Anderson, Francis and Stokes (1993). They demonstrated that as an organization's size increases - measured in terms of total market value - IA costs increase. Not only in absolute terms, but also in comparison with the amount spent on external audit. Spaakman then set up an experiment in which he used senior executives of Canadian governmental organizations. He asked respondents to evaluate the possibilities of using IA results to reduce costs. The results supported Transaction Cost Economics's prediction that IA results are useful in situations of high Asset Specificity. The uncertainty aspect was not supported. In fact, there was even a negative correlation.

This is consistent with the findings of Morril and Morril (2002). They concluded that if due to a high degree of Asset Specificity a thorough knowledge of the company is more important, external auditors tend to increasingly rely on internal audit. By contrast, they also concluded that uncertainty was not associated with increased internal audit participation in external audits.

Spaakman, again, found that size has a positive correlation with a need for internal audit. The larger the organization the more internal audit was needed. Therefore, Asset Specificity and size are the most determining factors. The limitations of the study are that it was an experiment and, therefore, only a limited amount of variables were dealt with.

Last but not least, regulation also had a positive effect on the existence of IA (Moxey, 1979). The US's Foreign Corrupt Practices Act of 1977 confronted managers with the need of having a good internal control system, and this increased the importance of IA.

Make or buy internal audit

Widener and Selto (1999) used Transaction Cost Economics to study the make or buy question. Noticing the trend of increased outsourcing (Cox, 1993; Schulz, 1995), they conducted a survey to examine possible explanations for it. Based on the Transaction Cost Economics literature, they made a number of assumptions related to the criteria of Asset Specificity, uncertainty and frequency (as developed by Williamson, 1985).

If internal audit is perceived as an added value, strengthening the competitive advantages of the organization by building up organization-specific knowledge, and if employees are trained or intellectual property rights are protected, the chances that internal audit will be placed within the organization increases. Even though specific knowledge will not immediately improve the competitive position, it is clear that audits require company-specific knowledge, which needs to be built up. Outsourcing is then not very likely. By contrast, when that knowledge is less specific, outsourcing remains a very viable option.

Other hypotheses link outsourcing with the degree of uncertainty (especially in the environment). Increasing uncertainty leads to a decreased pressure to outsource. The combination of Asset Specificity and uncertainty even enhanced that effect. The conclusions of Widener and Selto were that the higher the Asset Specificity the less outsourcing will be chosen. This is consistent with the findings of Williamson (1996). Further, they found that the more often internal audit is used, the more often the function is positioned internally. Their findings showed that high degrees of uncertainty and frequency did not correspond with an increase – or decrease for that matter - in internal audit being outsourced.

The qualitative analysis of the data supported the hypothesis that Asset Specificity is the most important driver for in-sourcing.

Agency Theory has also been used to model make or buy decisions for internal audit. Caplan and Kirschenheiter (2000) developed an agency model to create the most optimal contract with the external and the internal auditor. One of their conclusions was that outsourcing can be valuable without even taking into account differences in expertise. Their model assumed imperfect audit technology, and that the efforts of auditors are not observable. Given that it takes an auditor to assess another auditor, this seems to be a fair assumption. They varied the level of risk in their model, having management decide on the acceptable level and matching choice for an auditor. It turned out there were conditions in which the internal auditor was better rewarded than the external auditor for discovering discrepancies. Further, organizations that "make" Internal Audit do this because they expect that it will drive down external auditor fees. Their findings are consistent with the claims often made - but not necessarily always true - in publications and discussions. That is, internal auditors are cheaper and qualitatively inferior, and external auditors are more expensive and qualitatively better.

Remembering, once again, that their model does not necessarily square with all real life situations, it is safe to agree with them that external auditors have more to lose than internal auditors through errors. Not only in terms of reputation, but also successful liability claims (due to their "deep pockets"). Therefore, external auditors tend to do more testing than their internal brethren. Whether that is always for the right reasons - improving assurance, for example - remains subject debate. It just might be possible that internal auditors are more efficient.

Although not part of their model, an often heard argument is that external auditors work mainly within big audit firms where an "up or out" culture fosters better qualified staff. Caplan and Kirschenheiter included in their model the increased tendency of external auditors to focus on delivering internal audit services. This has been provoked by decreased revenues stemming from regular assurance services and the increased visibility and appreciation of internal audit shops. The latter argument contradicts the above case for the lack of competitive environment for internal auditors.

Up until now, internal auditors have been classified as employees and, therefore, have not been liable to claims in connection with poor performance. Thus as individuals, they have little to lose except their jobs and reputations. As we have seen with, say, Arthur Andersen, this is not at all the case with the big accountancy firms.

Caplan and Kirschenheiter's model also proved what most internal auditors recognize without thinking much about it. That is, since internal auditors are rewarded for finding deficiencies in the system and penalized for not finding those that surface later on as huge problems, they track down as many deficiencies as they can. While theoretical and pragmatic arguments could be made for and against this basic "covering your ass" policy, it is very definitely the right policy as far as managers are concerned. Because they assume that by discovering shortcomings the auditor is diligently doing his job. And that is exactly what he is getting paid to do.

> This is consistent with survey data by White and Xander 1984, who find that 40 percent of internal audit managers report that their staff believed they benefit from reporting as many deficiencies as possible. Furthermore, the survey result is consistent with our assumption that audit effort is unobservable, and hence is consistent with our description of auditing as subject to moral hazard. (Caplan, Kirschenheiter, 2000, 403)

Since it seems to offer explanations for a number of prevailing ideas and hunches, Caplan and Kirschenheiter's model deserves to be tested empirically.

4.5.3 Position

Agency Theory and Transaction Cost Economics provide some clues about IA's position and size. Using Agency Theory, Fama, (1980); and Fama and Jensen, (1980, 1983) showed that the larger the organization, the more reasons there are for separating ownership and control, thus causing a possible increased need to audit. They also demonstrated that by separating decision-management and -control this would be the case at all levels in the organization. The question then becomes if this would have consequences for IA's position? Is decentralization or centralization more preferred or justified?

In this section the following issues are discussed: IA's position, relative size, and how to deal with agency problems of the function itself.

Organizational Position

The organizational position relates to reporting levels. While that might sound trivial to some, it is particularly important for internal auditors (as we have already noticed in Chapter 2). Agency Theory explains why. IA provides information about the actions and results of agents.

Fama and Jensen argued for the separation of ownership and management, which would lead to more incompatibility between the interests. One party would tend to inflate numbers. the other to deflate them. The results would fall somewhere between the two, and that would be more reliable information. Every student auditor is very familiar with this highly valued dogma of segregation of duties.

But this contention only holds water when there is equality between the two positions. If one party is "the boss", all bets are off. Therefore, it is necessary to minimize situations where overrule is possible. Of course, that is only possible within limits, because top management will always be the buck stops here boss. But this inherent pre-eminence can be prevented by proper checks and balances. One of those is the external auditor, who is appointed by the Supervisory Board and reports to the Supervisory Board/Audit Committee. But even that only works within limits, because those checks and balances were in place with such blue chip companies as Enron, WorldCom, Ahold, Parmalat, and Shell, and that didn't prevent disaster.

In order to apply this concept here, IA should be independent of those they report about. As long as IA's mandate is focused on managerial levels below the Management Board the appropriate reporting level is the Management Board itself. If, however, the mandate is to include the Management Board a different position is required. If IA is to fulfill its duties with regard to the functioning of the Management Board - for instance in the case of auditing the "tone at the top" or the performance measurement system used as incentives for top management - this will almost certainly put the CAE under extreme pressure. Following Agency Theory, positioning IA under those it is supposed to monitor is a recipe for failure. And it should only be tolerated if everyone understands implicitly and explicitly that the Management Board will not be included in its auditing jurisdiction. If that is not acceptable to the decision makers, IA's preferred positioned should be under the jurisdiction of the Supervisory Board/Audit Committee (see Figure 1 in Chapter 1).

IA is of course also a "bonding" instrument to "signal" to supervisors that the agent is doing his utmost and is subject to audits. IA is also there to monitor the lower level managers [agents] on behalf of the Management Board. The external auditor, by contrast, is the monitor on behalf of the Supervisory Board. The second best solution, therefore, is to have IA report to the Management Board. If Fama and Jensen were followed, IA should be decentralized.

As already noted, Penno (1990) showed that Agency Theory does indeed provide some explanation for IA's organizational position. He concluded that it is more efficient if independence is optimized. Abdel-khalik, Snowball and Wragge (1983) presented similar findings. External auditors base their decision to use IA's work "by far" on the level it reports to. This is for them the ultimate proof of its degree of independence. San Miguel and Govindarajan (1984) also showed that independence is important. Using Agency Theory, they studied the relation betweens controllers and internal auditors. They hypothesized that a larger portion of internal and external compliance auditing and financial auditing happens in organizations where (divisional) controllers are less independent.

These hypotheses were supported by their research. They noted, somewhat incidentally, that they did not find any research about structuring and designing management control and the implications for internal audit.

> However, none have explored the implications of other internal control systems such as the internal audit function.… To achieve better financial control, the Securities and Exchange Commission and others have recommended that the internal audit function report directly to the audit committee of the board of directors, but research on the implications of this recommendation is lacking. (San Miguel, Govindarajan, 1984, 184)

Hopefully, this research will take us at least one small step in that direction.

IA's size

Research so far has not provided much support for answering the question, "How large should my IA be?" No research was found providing sound data about the absolute or even relative numbers.

Jensen and Meckling (1976) showed that auditing might reduce agency costs. Jones (1995) called contracts efficient if the sum of the agency costs is minimized. Consequently, the assumption could be that if agency costs are high the need for a higher quality audit is enhanced (see also Francis and Wilson, 1988). Whether this will lead to an increased IA size is not clear. The research of Francis and Wilson referred to external auditing, as was the case for that of Chow (1982). Based on Agency Theory, his research consisted of 165 companies. His conclusions, consistent with Jensen and Meckling, were that leverage (debt/equity ratio), size of the organization, and the need to use accounting specific information to appraise and reward managers indicated an enhanced need for audits. If the manager has a larger stake in the company, this need decreases. This is consistent with the expectation that an owner is more likely to act in his own best interest and monitor more closely what is happening, thereby reducing the need for audits.

Anderson, Francis and Stokes (1993) offered some insight into the relationship between internal and external audit. Since they studied corporate governance, they used the monitoring mechanisms of internal and external auditing, and boards/directors and sought the relationship between them. These monitoring variants should not be seen as substitutes but, rather, as complementaries to come up with an efficient mix. They used Agency Theory and Transaction Cost Economics and concluded that total monitoring costs increased - with a decreasing percentage - as the organization grew larger. They also showed that the greater the proportion of Asset Specificity, the greater the relative expenditure on monitoring from internal auditing as compared with external auditing

The restrictions of their study and the model make the above findings more suggestive than conclusive. The model was dominated by executive directors (in comparison with non-executives) and excluded rewarding them by means of stock options. Accounting measures were used and were, therefore, imperfect. Last and probably not least, the focus was on larger Australian organizations.

Nevertheless, Agency Theory and Transaction Cost Economics provided clues relation to IA position and size. The larger the Information Asymmetry and the higher the degree of Asset Specificity, the larger IA will be and the more reasons there are to make it in-house (make).

How to deal with IA's agency problem

There is also a principal-agent relationship between the auditor and the principal hiring his services. Antle (1982) described the auditor as another economic agent.

> Unless we believe that auditors are somehow qualitatively different from the other types of economic agents that we study, it would seem that we should attempt to apply the same techniques to modeling auditors that we use to model other economic agents. (1982, 503-504)

Antle developed a model in which incentives for the auditor were endogenous and it was the auditor's role to provide information used by the principal for his governance task. Included among the models he used were those of Harris and Raviv (1979) and Holmström (1979). In the former, the agent is risk adverse. In the latter, auditor-provided information contributes to better contracting. His conclusion was that the auditor is an economic agent. He verifies the information presented to the principal by the agent, and thereby increasing reliability of the data.

The model also proved that risk sharing between the auditor-agent and the principal is necessary, expressed by the incentives the principal awards the auditor-agent. The auditor-agent can be risk-and work-adverse and shirk chores and choices. The principal therefore offers him a contract in which penalties are demanded in cases of errors or insufficient effort. This works especially well when the auditor has "deep pockets". Otherwise, it will be more like trying to squeeze blood from a stone. Judging from this assumption, it becomes clear that Antle has applied his model to the external auditor working for a large public firm and assumed to have such deep pockets. The penalties led to risks being transferred from the principal to the auditor-agent, justifying the assumption that the auditor will do more to ensure reliability on what gets his stamp of approval.

His model of a principal dealing with two agents (auditor and manager) is more complicated, because these two agents have an agent-principal relationship of their own. The auditor performs audits at the behest of the manager. It is possible that the auditor and the manager will make agreements together (see also Kofman and Lawarrée, 1993). They can both be risk- and work-adverse and wind up - either from the beginning or somewhere along the line - in an "I'll scratch your back and you scratch mine" relationship. One may lie and the other will swear to it. Manager reports will not be checked by the auditor. This creates considerable problems for the principal. While Antle provided some mathematical "solutions" in his model, he admitted that they were neither simple nor realistic.

> Two possibilities for overcoming the randomized strategy problem were suggested: change the rules of the game and/or impose convexity conditions. The former seems unjustifiable in an auditing context and the latter promising but difficult to achieve. (1982, 526)

Penno (1990) also researched the problem of internal auditor incentives.

> Because an internal auditor is another economic agent, capable of self-interested behaviour, problems of motivation similar to those of the agent studied here may arise. The internal audit function will be designated as effective for incentive purposes … when the internal auditor meets with and honestly receives and verifies disclosures from the agent. Such a relationship may be possible when the internal auditor is paid a wage (by a superior at a level higher than both the internal auditor and employee being evaluated) conditional on supplying properly documented reports. (1990, 524-525)

Sharma (1997) took a different approach to the problem of the auditor being an agent. The auditor is a "professional", which leads to specific agency problems. Normally, agency problems are limited to Information Asymmetry. But in this case knowledge Asymmetry also exists. Auditors have specialized knowledge and skills that the principal does not have. This creates an extra problem.

Sharma cites Abbott (1988) when he says: "that the key distinguishing characteristic of professions is that they are based in abstract bodies of knowledge" (Sharma, 1997, 763). The underlying assumption is that clients of their services are not experts and, therefore, can and should not interfere with how the service is provided. In cases where opportunism and lack of trust are either known to exist or highly likely, this dependency could lead to the professionals exploiting their clients.

A counter-balance to that very real possibility is an assumed degree of "gentlemanly" altruism on the part of the professional - his professional pride and honor. This will lead him to doing the right thing, consciously and consistently. Another weight on the side of the angels is peer review.

According to Sharma, professionals distinguish themselves in three areas: Power Asymmetry, Oversight and Co-production. Below those three areas will be briefly discussed.

Power Asymmetry

The fact that the principal is not capable of creating, monitoring and enforcing a good contract is the most important difference with other agents. Walsh and Seward (1990) wrote an essay about the efficiency of corporate control mechanisms based on good contracts. In this kind of asymmetry, that is fatally flawed.

Principals can of course again invest in information about the professional to gain better insights. But this does not solve the problem of having limited possibilities of evaluating the results. Sharma distinguished information on "what the agent does" from "how the agent does it". This distinction is very important because information concerning the "what" question is for sale, but the "how" is not. The latter is changing continuously. This creates not only an ex post problem, but also an ex ante one. How much and what exactly should be contracted? This question is critical for determining the need for internal audit and its Scope of Services. The auditor is often the one determining what tasks are to be performed, and how. Normally, the party contracting any service is capable of making up his mind on the what, how and how much issue. In the case of specific knowledge intensive services this capability is significantly limited. This led Sharma to the following conclusion.

> Consequently, the power Asymmetry assumed in agency theory is reversed in exchanges involving professional agents who have the power over lay principals because they control relevant task-related knowledge and have the expert authority to influence greatly (if not drive) the standards of exchange. (1997, 770)

Oversight

In cases where monitoring and measuring costs are low, Agency Theory offers good solutions for agency problems. The problem in this case is that the costs of monitoring and measurement are high, because specific knowledge is involved. Behaviour- and outcome-based contracts are inadequate. Walsh and Seward (1990) described controls based on internal organizational measures or external market oriented variants. But they only offer partial solutions, and opportunism cannot be adequately addressed. Sharma proposed supervision by peers within the organization or profession-wide measurements, such as codes of conduct and ethics, diplomas (licensing) and auditing.

Sharma is convinced that the first option offers more guarantees than the second one. I disagree, because intra-organizational supervision lacks the necessary independence that enhances credibility. The IIA Inc. made external quality reviews mandatory every five years and the IIA the Netherlands developed a quality review scheme that provides peer review by the profession. One must keep in mind, however, that professional peer reviews are no longer permitted for the external audit profession. Those tasks are carried out by US' Public Company Accounting Oversight Board (PCAOB) and The Netherlands Autoriteit Financiële Markten (AFM).

Co-production

Berle and Means (1932) stated that "most fundamental of all, the position of ownership has changed from that of an active to that of a passive agent". Professionals work together with the client to create an advantage. It often involves intangibles that demand an ongoing dialogue between professional and client to discover their often changing needs and demands. Auditors also deliver such services and are in a continuous dialogue with the client to perform the right activities to satisfy the client's requirements.

Sharma (1997, 775) developed a model to overcome the obstacles in the way of monitoring any professional. He used the following four sorts of controls: community (professional body), self, bureaucratic (using policies, procedures, etc. at the organizational level) and client.

Community control presupposes that professionals behaving badly will disciplined by other professionals. In other words, there will be clear negative impacts in terms of reputation.
Williamson, however, stipulated that these sorts of deterrents are only viable if it is clear that the principal is not to partially or fully to blame. Otherwise, the agent can counter claim that the principal is the problem. (Williamson, 1985, 396). Further, the information about suspected wrongdoing needs to be communicated in an efficient way to as many people as possible in order to be effective, which is costly.

Of course, many professions, including internal auditors, have professional associations with journals where negative verdicts can be published. However, since the larger public is hardly likely to be on the subscription list, they won't know anything about it. Therefore, the spread of this information will be incomplete. The profession plays an important role in improving the functioning of this "reputation" market. The IIA The Netherlands and the VRO[67] have their own professional and ethical rules and disciplinary powers. In their (relatively short) life times there have been no cases where these powers have been invoked.

Kofman and Lawarrée (1993) introduced a third party in the traditional principal-agent model: an auditor/supervisor. Just as in Antle (1982) this person is appointed to provide the owners-principals with information that will help mitigate the problem of Information Asymmetry. The advantage of their contribution is that they take into account not only the external auditor, but the internal as well and ascertain which combination should be preferred.

Apart from agency problems, Williamson (1985) acknowledged that internal auditors are more exposed to collusive pressures. Thus he asked the probing question: "Are the flaws of internal auditing remediable?" Alas, he did not offer an answer. Let's "warm" ourselves in the idea that it is.

Kofman and Lawarrée attempted to fix the flaws by applying Agency Theory. They mentioned that the external auditor could qualify as an internal auditor. That would let the principal appoint him to supervise the internal auditor. And vice versa, the internal auditor could supervise the external auditor. The extra costs to be carried by the principal. True, it is a sound practice to employ the external auditor to supervise on a random basis the internal auditor to reduce the risk of conspiracy between internal auditor and agent. But they have

[67] Vereniging van Operational Auditors (Association of Operational Auditors).

assumed that the external auditor himself will never conspire, which is of course a rather dubious assumption.

The last option to keep professionals at a certain leash is to have the client do it himself. There are several possibilities for that. One of them is "unbundling". Parts of an assignment are distributed among other service providers, which creates an incentive for all parties to have the other(s) perform well. This leads to mutual monitoring. Another is to hire a knowledgeable expert to supervise the auditor.

Therefore, in many regulations it is ruled that when organizations outsource internal audit, they are is obliged to have sufficient expertise to supervise the activities. This is called the internalization of specific knowledge and expertise, which decreases the tendency of the professional to behave opportunistically.

4.5.4 Scope of Services

In this section attention will be paid to the Scope of Services and the relationship with the external auditor.

Scope of Services

From an Agency Theory perspective, principals are many times not able to assess the behaviour of their agents and use rewards and incentives to get the best out of them. It is therefore, evident that incentives and rewards are a determining factor for the behaviour of managers and almost inevitably should be included in IA's Scope of Services.

That this is not easy is shown in the studies of Jensen and Murphy. In 1990 they questioned whether top managers were being rewarded as adequately as they deserved. But in 2004 they concluded that the system was over compensating - literally! - and listed 38 (!!) recommendations to counter possible dysfunctional behaviour by top management. They emphasize that the Audit Committee should carefully scrutinize and monitor the use of performance metrics and remuneration policies.

Could IA support them in that task? Up until now the only reported case of IA helping to uncover the sleaze was WorldCom. Cynthia Cooper, named Woman of the Year in 2002, headed the internal audit department of WorldCom and was proclaimed as the one who "blew the whistle". Thornburgh (2003), the court examiner of WorldCom, subsequently reported the outcomes of his findings. Although he gave full marks to Mrs. Cooper, he criticized the IA. It lacked an adequate budget and support form top management, had the wrong Scope of Services - there was too much focus on "adding value'" to top management instead of being "an internal control police". While Mrs. Cooper is no longer in office, WorldCom's IA now has a bigger mandate and more staff. Closing the Information Asymmetry gap as so eloquently defined by Agency Theory, IA would need to focus on the reliability of reporting, in many cases mainly containing financial data and to some extent non-financial data.

Much research in the area of management control uses Agency Theory.[68] But Transaction Cost Economics is catching up[69]. In fact, Transaction Cost Economics may be better suited to point at which clues to look for when going beyond the traditional reliability of data. The most appropriate variant would be auditing the Management Control System. Having said that, this area is so broad that one cannot say in advance what is subject to internal auditing and what is not. It is necessary to first come up with a more descriptive narrative of what should be included in the Scope of Services.

The Transaction Cost Economics debate around the question whether transactions will be carried out through the market or within an organization and, consequently, the institutional choice for a governance structure becomes relevant. The governance structure and the institutional agreements largely determine the behaviour and efficiency of the economic actor (Williamson, 1979, 235). This is of particular interest for internal auditors, because they need to provide assurance about behaviour and efficiency issues. Internal auditors are expected to assess whether agents have acted in the best interest of principals.

Obviously, if property rights are wrongly assigned, the behaviour of agents will be affected and their output will be affected negatively. Therefore, internal auditors will need to take into account the way "property rights" are assigned. From the perspective of the organization this means that proper authority needs to be assigned to any manager. Property rights translated to the level of the organization would lead to transferring the right level of authority to managers in order to be able to become the central party for assessing team members and deciding who is to be on the team and who is not. Some live up to expectations. Others do not. If the manager has no authority or right to change team membership, his ability to bring in the best team performance is seriously hampered. Internal auditors, therefore, should be required to assess the appropriateness of authority at all levels.

The previous sections revealed that Asset Specificity is one of the most important determinants for governance structure. Therefore, it is of interest for internal auditors for at least three reasons. One, there is a need to understand the mechanics of Transaction Cost Economics, because their underlying assumptions will affect any contract and subsequent governance structure. Transaction Cost Economics presupposes that the ability to economize on transaction costs will be affected by the governance structure. The governance structure is part of the Management Control System. Internal auditors, therefore, need to assess the quality of the Management Control System. In that respect, awareness of Transaction Cost Economics will be needed to be able to define their Scope of Services in general and the specifics of any work program for any audit they undertake. Two, the assumptions of Transaction Cost Economics will impact their contract and the way they are governed as well. The more specific their knowledge, the more difficulties there will be in drafting *ex ante* performance metrics and expected outcomes of their contract. Measurement *ex post* will also be difficult. Three, Transaction Cost Economics is applied mainly in the "make or buy" decision, which is also of special interest for internal audit. The latter will be dealt with in more detail in section 4.6.2.2.

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[68] Chua, Lowe, and Puxty, 1989; Fischer, 1995; Langfield-Smith, 1997; Simons, 1990, 1995a, 1995b; Otley 1994; Otley and Berry, 1994; Flamholtz, 1996a, 1996b; Merchant, 1982, 1997; Merchant and Van der Stede, 2003; Ouchi, 1977, 1978, 1979; Barney and Ouchi, 1986; Flamholtz, Das, and Tsui, 1985; Goold and Quinn, 1999

[69] Van der Meer-Kooistra, 1994, Van der Meer-Kooistra (1998) and Vosselman, 2000; Seal, 1993; Speklé, 2001a, 2001b; Covaleski, Dirsmith, and Samuel, 2003

Jensen (1983, 325) came up with a description of three systems important for any organization: performance measurement and evaluation; rewards and punishments; and exercising and awarding decision rights among players.

Lowe (1971) defined management control as follows:

> A system of organizational information seeking and gathering, accountability and feedback designed to ensure that the enterprise adapts to changes in its substantive environment and that the work behaviour of its employees is measured by reference to a set of operational sub-goals (which conform with overall objectives) so that the discrepancy between the two can be reconciled and corrected for. (Lowe, 1971, 5)

This follows the need to pay attention to an organization's adaptive capacity. In that sense this follows Williamson (1985) who made adaptation a central theme of Transaction Cost Economics.

Giglioni and Bedeian (1974) indicated that control in complex organizations consists of two types. One involves providing direction for the activities of subordinates by means of procedures and standard work regulations. This is realized via the organizational structure, culture, human resource policies, etc. Simons (1996) would call this a "belief system" and "boundary system". The second type involves cybernetic control. Simons (1996) would call this the "diagnostic control system", which aims at measuring results and providing feedback with respect to the question, "are we on the right track?". Many other writers[70] considered that a formal control system should be cybernetic by nature.

A helpful framework for the components of a Management Control System was provided by Rotch (1993). He identified five: performance measurement; strategy (in contrast with Anthony (1988)); organizational structure; direction; and motivation.

What is interesting is that his model takes into account the human factor via motivation, direction and leadership style. It also acknowledges the importance of feedback and the rewards and incentives, as was already predicted by Agency Theory. Last but not least, it also refers to the area of organizational change, acknowledging that a Management Control System is subject to change because of changes in the company, strategy (see Chandlers famous quote: "Structure follows Strategy"), or environment. As has already been shown in this chapter, rewards and incentives are very important factors to drive the behaviour of people in desired directions, especially when objectives need to be reached.

Many researchers had a cybernetic perspective on management control because of the way their thinking was influenced by the machine perspective that developed out of the industrial revolution (Morgan, 1986). They looked at organizations in a rather technical manner. As something that could be reduced to formulas and made to operate at will. If you want it to go left, then do this and it will turn left. If you want it to turn right, do that. How this cybernetic perspective influenced Management Control System research was demonstrated by Tocher (1970, 1976) and Otley and Berry (1980). Others, such as Paape (1999), De Korte and Hartog (2005) argued that many internal auditors predominantly use the basic cybernetic perspective

[70] Green and Welsh, 1988; Otley and Berry, 1980; Fisher, 1995; and Anthony, 1988

as a fundamental starting point for their work. The cybernetic perspective is also dominant in many text books used in the curricula of chartered accountants and auditors.

What's more, since organizations are constantly adapting to the environment, models also need to adapt accordingly. As already noted on more than one occasion, Williamson made adaptation one of the cornerstones of Transaction Cost Economics. Interestingly, both Rotch (1993) and Otley and Berry (1982) included producing change in their models. Numerous authors (Kloot, 1997, Argyris, 1990, Simons, 1995a) acknowledged the necessity of what they call "double loop learning". What's that? Single loop learning ensures that, say, there are technicians who can keep the temperature at a pre-ordained level. Double loop learning calls for smarter technicians. They must not only master the first trick, but also be able to ask and answer such questions as, "is the pre-ordained temperature what we need now?" and "are there other ways of getting there?".

Both Transaction Cost Economics and Agency Theory have been criticized because their underlying assumptions about human behaviour do not include trust. This criticism has also been directed at the literature on Management Control Systems. "A Management Information System that aspires to be foolproof … indicates lack of trust on the part of the user…. Subordinates' reactions will tend to be to continuously make management's assertion that they must be monitoring and controlling a self-fulfilling prophecy" (Argyris and Schon, 1978).

Goold and Quinn (1990) agreed that trust should be part of Management Control System' domain. "Trust and confidence are, indeed, at the heart of any well-functioning control system." (1990, 53) But others see this differently and could very well be in Williamson's camp. That is, where they see trust, he sees opportunism. "Rather than performing well, employees often set low goals that can be easily met, manipulate measures to come out with the desired results and actually sabotage the system's information base." (Camman and Naddler, 1976, 67)

It is the belief of Goold and Campbell that trust and control are connected. One could say that there is no trust without control. A control system can stimulate and boost mutual trust (Goold and Campbell, 1987) for three reasons. First, a track record of realized results inspires trust in higher management. Second, reactions caused by deviations between plan and realization create an image of a strong (or weak) management and their understanding of the business (or lack thereof). Third, the control process provides an opportunity for clear personal feedback.

Summarizing the insights obtained up to now, in order to define IA's Scope of Services, we have to take as a starting point assessing the quality of an organization's Management Control System in a broad sense. Based on that, the following may be included in the Scope of Services.

1. The processes and functions that deal with the question of the strategic direction in which the organization is moving. Simons (1995b) would call this the "interactive control systems", which should provide an answer to the question "are we doing the right things", and, therefore, ensure adequate adaptation.
2. Goal and objective setting and aligning with stakeholders (corporate governance).
3. Organizational structure
4. The way in which authority is distributed (property rights, characterized as "decision management" and "decision control", as described by Fama and Jensen, 1983,).

5. The culture of the organization, characterized by leadership style and values (e.g.,a code of conduct).
6. Planning and control cycles
7. Feedback mechanisms based on information and reporting.
8. Performance measurement systems
9. Reward and incentive systems
10. How feedback is generated and adjustments take place when processes and systems do not function as intended (adaptation and learning capacity).
11. How adaptation is ensured and required changes are produced, including challenging paradigms that are being used.

All of the above can, and should, be taken into account when drafting IA's Scope of Services. The problem is that one could come up with countless components of a Management Control System. But there is more to it than naming and listing them. The significant question is "what components, to what extent, and in what combinations best help cope with existing control problems?". That is a matter of effectiveness and efficiency, which will not be addressed here.

Relation with the external auditor

Agency Theory and Transaction Cost Economics offer explanations for the relationship between the internal and the external auditor (see Sharma, 1997; Kofman and Lawarrée; 1993). Adams (1994) assumed that management sees internal audit as a mechanism to supervise external auditors and control costs. Of course this is also possible the other way around. Kofman and Lawarrée (1993) made it clear that the external auditor can be asked to monitor the internal auditor.

A number of other studies have been carried out on this subject: Brink and Witt, (1982), Engle (1999), Felix, Gramling and Maletta (1998), Moore and Hodgson (1993). The IIA Professional Standards and the AICPA (Statement on Auditing Standards number 65), point at positive effects and the need for coordinating the efforts of both internal and external auditor. Engle (1999) points out that a good coordination leads to better audit coverage. The advantages of a good coordination are a decrease in audit costs (especially external), increased quality of the audit, more security about the correctness of the reports, and the external auditor keeping the internal auditor sharp. There is also the danger of too close cooperation leading to collusion.

Morris and Morris (2002) used Transaction Cost Economics to gain more insight into the decision to use internal auditors for the external audit. Such a decision is comparable to the make or buy issue. Felix, Gramling and Maletta (1998) demonstrated that the trend to establish closer coordination between internal and external auditor – especially IA's increased input in EA's results - is predominantly caused by:

1. The consequences of the 1992 COSO report (see Chapter 3).
2. The pressure on external auditor fees, which led them to search for other fields to plow, including traditional IA tasks (see also Caplan and Kirschenheiter, 2001).
3. The quest of IIA Inc. for more status for the internal audit profession.

Transaction Cost Economics might also offer an explanation for the most efficient decision by management for the use of external audit. Levinthal (1988), among others, discovered that complexity and Asset Specificity had a positive influence on the duration of the external auditor-client relationship. The higher the level of complexity and Asset Specificity, the longer the relationship lasted. This makes sense, because it takes time to acquire the necessary specialized knowledge to adequately fulfill the tasks. This is also acknowledged by Williamson (1985) and Speklé (2001a).

Another other form of uncertainty is behavioural (Williamson, 1985). Williamson indicated that if this is high, it is more likely that transactions will be internalized. Such transactions are harder to measure and monitor and, therefore, it is more logical to use internal audit. The external auditor will then also lean more heavily on the internal auditor. According to Morris and Morris (2002), human Asset Specificity is a particularly important determinant for the relationship between external auditor and client. In cases of transaction specific investments, knowledge of the organization is very important to perform a good audit and assess whether the auditor has performed well. This finding is consistent with the findings of Widener and Selto (1999). The auditor has to make a decent investment to acquire the specific knowledge. Transaction Cost Economics predicts that organizations will probably start using internal auditors because they work within the organization and will, therefore, acquire this knowledge faster than their external brethren. This is also more cost efficient. Engle (1999, 67) corroborates Williamson's view:

> ….internal auditors who are intimately familiar with the organization under review are in an ideal position to provide information about the "business" behind the financial statements.

The hypothesis is that internal auditors will be used more frequently than external auditors when there is a need for significant audit specific knowledge. Morris and Morris concluded that specific audit related knowledge is strongly associated with the use of internal audit for external audit tasks. This is consistent with the empirical results of Transaction Cost Economics. Further, this specific knowledge is more important than measures of uncertainty and complexity.

An often-heard argument is that the use of internal auditors can decrease the costs of the external audit. Felix, Gramling and Maletta (2001) repeated their 1998 study and concluded that the level internal audit contribution to the external auditor's financial audit is an important indicator for the external audit fee. This is consistent with the findings of Wallace (1984). If management empowers a high quality IAF and emphasizes the need for coordination between the internal and the external auditor, there were significant savings - up to 20% - on the external audit fees.

4.6 Conclusions

Throughout Chapter 2 we described the current state of internal audit and concluded that it was in definite need of theory to provide "a place to stand". So it wouldn't go on slipping and sliding and be susceptible to the whims of this or that Management Board, Supervisory Board/Audit Committee, regulator, or fashion. We decided that both Agency Theory and Transaction Cost Economics were theories worth exploring to take some steps in the right direction. In this chapter we have investigated both their background and applicability to internal audit. Agency Theory is essentially about 3rd order economizing, getting right marginal conditions, resource allocation and employment, and providing insight for the continuous process of aligning goals and objectives of agents and principals through incentives and rewards. Transaction Cost Economics is about 2nd order economizing and focuses on governance structure. How to play the game. Which governance structure is best suited to deal with economizing on transaction costs and adaptation.

Both theories share a fair amount of common ground. For example, such behavioural assumptions as bounded rationality and opportunism. Many studies emphasize that the two are complementary, and combining them might pack more punch when it comes to explaining how organizations do, and perhaps even should, work. Current research using one or both to tackle the topic of audit is based on the notion of the external auditor. Research devoted to the internal auditor is limited.

Nevertheless, taking stock of what theory does provide, we see that Agency Theory's Information Asymmetry is the dominant factor used to explain the rationale of auditing in general. And we are quite confident that it is also valid for explaining the raison d'être of internal audit in particular. The higher the level of Information Asymmetry - hidden information and hidden actions - the sooner audit in general and internal audit in particular is deemed necessary. It might also provide some tantalizing clues to our other issues. That is, IA's position, Scope of Services, size, relationship with the external auditor, and the make or buy issue. It also sheds light on how to deal with IA's agency problem.

But, unfortunately, there are some challenges. One is that the concepts have been defined and researched for the gap between outside and inside organizations. They have hardly ever been defined and researched for the intra organizational gap between higher and lower managerial levels. This is, of course, an area of particular interest to explain the role and rationale of internal audit. If we could define some proxies to measure that level, we would at least be able to use that yardstick to find a relationship between the degree of Information Asymmetry and the presence of internal audit and perhaps even its size. For example, the bigger the size of the organization, the more Information Asymmetry is expected. Thus, perhaps that should also mean a larger IAF. What's more, economies of scale would permit - or even compel - an in-house department. Thus answering the make or buy question in favour of make.

Agency Theory is about principal-agent relationships and how to make sure that what is being done by the agent is geared towards the best interest of the principal. It predicts the use of monitoring and monitors, and auditing and auditors naturally slot into those needs. But an important distinction needs to be made. This activity is called "monitoring" from the perspective of the principal. It is called "bonding" from the perspective of the agent, who also has his needs vis-à-vis the principal. One of them is to demonstrate that he is doing his job, and doing it well.

One way of doing this is to show the principal his awareness and appreciation of agency problems, and the steps he has taken to overcome them. For example, by using auditing - in this case, internal auditing - to research and write reports indicating that the principal's interests are being looked after. In other words, top management, which is an agent vis-à-vis principals - called shareholders - but a principal vis-à-vis IA, also benefits from the existence of Internal Audit.

In this respect, IA's organizational position is important. In order to gain credibility as a reliable witness in the eyes of the principal - that is the shareholders and their other agents (Supervisory Board/Audit Committee) - IA has to be perceived as being both independent and objective. Put negatively and rather bluntly, he can't be seen as being the errand boy of top management. But, as we saw in Chapter 2, both independence and objectivity and relative terms, and we should not be dazzled by their grammatical simplicity and mistake them for absolutes.

While the organizational position for the IA may solve the Management Board's bonding problems, it doesn't effectively address the principal's monitoring concerns. Those are addressed - sometimes not that effectively, as many serial scandals have demonstrated all too well - by the external auditor, which is hired by the Supervisory Board. But, in theory at least, the "principle of the principal" is valid. Thus, in order to really help solve the principal's monitoring problems, IA should be working for the true principals. That is, shareholders. Not agents masquerading as principals. That is, top management.

The principal's agency problem vis-à-vis the Management Board could be addressed by expanding the mandate of IA's Scope of Services to include the operations of the Management Board itself. And at first, and perhaps even second, glance, that appears to be a valid option. But then a few advantages that Internal Audit has over external auditor would go out the window. According to Williamson, one of Transaction Cost Economics's major expounders and proponents, one of these advantages is a greater perceptive reach into the organization. Because the internal auditor is "one of us", people within trust him more than the external auditor and are more prone to open up and even point to where the bodies are buried.

This according to Williamson. Another advantage, according to Williamson, is that the internal auditor is more flexible than the external. Since he is not subject to limiting professional standards, it is easier for him to "ad lib", "go with the flow" and adjust his investigatory approach to suit the needs of the organization. However, while that may have been true where and when he conceived that advantage (1985), it is no longer the case now. Or at least not always. Because while Internal Audit's standards may not be as rigid as external auditors, they are quite high and professional. But, as we have already seen, this might not be true among all passing muster under the category of "internal auditor". And it might not even be true for the majority of them.

There might be another argument in favour of Internal Audit. External auditors are highly subject to scrutiny by regulators. And it doesn't require any stretch of the imagination to picture instances where both principals and agents would prefer to keep organization-specific knowledge outside of the public domain. In this context it is interesting to note that the Public Information Officer (PIO) in many, if not all, governmental departments and agencies, remains outside the loop in much of the deniable wheelings and dealings that go on behind the scenes. What he doesn't know, he doesn't have to hum, haw or lie about. This aspect might be of some interest when deciding whether auditing of the Management Board should be in the hands of external auditor or Internal Audit.

Another area of contention is incentives and remuneration, which, according to Agency Theory, are the main instruments used to steer behaviour. They are critical for the success of any organization, and thus serve everyone's interests, but most especially those of the principal. Reviewing these - in the context of assessing Management Control Systems - could, conceivably, be placed in the external auditor's mandate. But based on what we have learned so far, that suggestion will probably be put on the shelf of bad ideas. This assessment could be placed in the hands of the Supervisory Board. But they probably don't have either the time or the necessary knowledge to do the job well. Thus the most likely candidate for the task seems to be, again, IA.

Agency Theory provides evidence that an essential part of good governance is a Management Board that functions well. Transaction Cost Economics provides evidence that good governance structure is crucial in adapting to environmental changes. And it goes without saying that governance is the same as "corporate governance" and is subject to those regulations. Thus governance, and the issues swirling around that rather entangled topic, should be subject to auditing. But who should do it? Or, taking one step backwards, whose input should be solicited before making those sorts of decisions?

Obviously, the arguments that have been presented above are relevant for addressing these sorts of issues, even if they can't promise to definitively solve them one way or the other.

Agency Theory has something to bring to the table when the issue of monitoring IA itself is on the agenda. As it should. Since internal auditors are also economic agents and as human as everyone else, there are no a priori reasons to expect that their morality and resistance to temptation is higher than anyone else's. And no a posteriori reasons either.

And there is no shortage of already on the shelf instruments that might, with one catch and one exception, adequately deal with this issue. First, the catch. Some, if not all, of them have to be taken off that shelf and put to work. These include establishing a code of conduct and requiring adherence to it and internal quality control measures. Another is performance-based remuneration of the internal auditor, where performance is determined by finding shortcomings in the organizations control mechanisms, and, possibly, penalizing auditors that don't detect these shortcomings in time. Other instruments are: ad random checks by external auditor on the functioning of Internal Audit; giving preference to qualified auditors; credible disciplinary rules; and adherence to the professional standards of the IIA Inc.

Now the exception. Implementing all of the above makes perfect sense to any contemporary professional internal auditor worth his salt. Except for one that sticks out like a sore thumb. That is the performance-based remuneration bit. To some extent this was already addressed in Chapter 2. But at this point I would like to foreshadow something that will be dealt with in more detail in Chapters 5 and 6.

Agency Theory is unmistakably clear about steering the behaviour of agents through incentives and remuneration. However, while the IIA Inc.'s Standards of Professional Practice do not prohibit such carrots, many internal auditors are uneasy about having them waved in front of their noses. Many strongly believe, and to some extent rightly so, that these will further affect their ability to both be and be perceived as being independent and objective. While there is no denying that danger, it can be circumvented if the metrics do not touch those areas that the auditor is assessing. For example, the organization's financial results and stock option plans. They should be connected with achieving specific, pre-agreed upon goals and provide the CAE and IA with opportunities to earn pay out bonuses. This will raise not only their standards of living, but those of the profession as well. It will help internal audit to both attract and retain the best and the brightest.

Regarding the make or buy issue, Transaction Cost Economics has a lot to contribute to flesh out the discussion, if not to actually provide some conclusive answers. The key words in this context are "Asset Specificity". According to Transaction Cost Economics, the higher the Asset Specificity, the better the argument is for make. One of the elements of Asset Specificity is knowledge. In the Internal Audit context, it is well known that highly organization-specific knowledge is required to perform the audits included in its Scope of Services. However, there is another catch. That is the boundary issue. As the incomplete list of audits mentioned at the beginning of Chapter 1 indicates, a lot of highly specific knowledge is required to adequately perform IA's duties. But at a certain point the bubble will burst, and it will be more economic to outsource some of its activities. Thus, in some cases the answer to the question, "make or buy?" will be, "make and buy".

We can say that Agency Theory and Transaction Cost Economics have created at least some inroads into all of our main questions. And some of them, especially in the area of the IA's role and rationale, are much more useful. In Appendix 1 the gains we've got from both Agency Theory and Transaction Cost Economics are shown. One has to keep in mind that these findings are presented as revealed by the research. It shows that not all research (sub)questions are equally adressed (if at all). As such, this underscores the fact that the available theory is not comprehensive and conclusive. Therfore, it was decided to further investigate real life via case studies and research whether these results would hold or even can be extended. Chapter 5 elaborates the results of the case studies.

Chapter 5 Case Studies

5.1 Introduction

In Chapter 2 I attempted to demonstrate the confused and chaotic state of affairs of the Internal Audit profession. In Chapter 3 I investigated the developments around Corporate Governance (Corporate Governance) and learned that these impact IA. In Chapter 4 I examined two theories - Agency Theory and Transaction Cost Economics - which at first and second glance seemed to offer - in the words of Archimedes' famous ancient saying - "a place to stand".

And, indeed, Agency Theory does provide evidence for the rationale of IA. It has a role to play in limiting Information Asymmetry. The higher the degree of Information Asymmetry within an organization, the more likely there will be an IAF. And as the organization increases in size, the more likely it will be internalized. Does it say anything about absolute numbers? For example, for x number of employees there will be y number of IA staff members. Unfortunately not. But it has something to contribute regarding where to position IA. It is best to have it as close as possible to the principal. The issue then becomes who is IA's principal? In other words, who should it be the agent for? It is my contention that the natural choice is the Supervisory Board, which monitors the Management Board on behalf of shareholders. This will enhance its independence. But there is an external auditor, which is already in the hands of the Supervisory Board. Wouldn't it then be better to expand the external auditor's mandate to include IA tasks?

Transaction Cost Economics has a few things to say about that. The higher the degree of Asset Specificity, the more likely it will be that capabilities will be internalized. It is fair to say that IA, especially in cases of high Asset Specificity, needs highly specialized knowledge. Knowledge that is more easily acquired inside the organization. Further, since contracts are incomplete by nature Transaction Cost Economics has more to offer. Information about whether provisions of contracts are being lived up needs to be obtained. Williamson said this would be easier for insiders than outsiders because they are perceived as "being one of us". Plus, according to Williamson, internalized staff have more flexibility than external. The combination of high degrees of Information Asymmetry and Asset Specificity would more likely create an increased need to have an internalized IA. Its scale will then be larger for three reasons. One, the need for IA services in general will be bigger. Two, the specialized knowledge is easier acquired internally. Three, the scope of services in those particular circumstances will be broader because the need for information on various aspects will be larger. This might also drive IA's size.

Agency Theory also produced overwhelming evidence that demonstrates that reward and incentive systems are widely used to steer the behaviour of agents toward the best interests of principals. Thus when assessing the adequacy of Management Control Systems, one cannot exclude this from IA's scope of services. In that respect, Transaction Cost Economics offered some insights in the variety of the management control system that also includes such elements as leadership style and – as some call it – "culture". Thus monitoring the way the organization is governed and the activities of the Management Board would best be included within IA's scope of services. Transaction Cost Economics had previously claimed that it is wise to broaden IA's scope beyond the traditional financial audit anyway, since this offers more opportunities to add value to the organization.

Agency Theory has also demonstrated in more than one way the value of performance based rewards and incentives. The internal auditor, being an economic agent, should also be subject to that. If carefully chosen, performance based metrics and appropriate rewards and incentives offer solutions to the risks of moral hazard and opportunism, which also affect the internal auditor. Thus Agency Theory also offers ideas on how to monitor him and limit those risks. One of them is having him monitored by a knowledgeable expert: the nearest one being the external auditor. This and the need for EA and IA to combine efforts also explains the need to have a sound coordination between the two.

Have Agency Theory and Transaction Cost Economics provided enough to deal with all our main issues? Again the answer is unfortunately not. Most of the research using these theories up to now has been devoted to external audit. And even a lot of that is rough and tumble at best. Research on IA is still in its infancy. Nevertheless, when both Agency Theory and Transaction Cost Economics are stripped of their come hither allure - to provide one- or two-stop shopping answers for our concerns - they remain as reasonably good starting point for some of them. As far as theory is concerned, there is room for improvement. As such, that's a perfect opportunity for designing, developing, carrying out and analyzing case studies. The results of the case studies that were done are dealt with in this Chapter.

This chapter begins where the last one left off. I begin with research methodology, proceed to the case studies themselves and follow through with discussion and some conclusions.

5.2 Research Methodology: Case Studies: Theoretical and Practical Considerations

Introduction

According to Yin (1994, 2003), a case study approach is particularly valuable when little is known about a phenomenon and when asking how and why questions about a set of unfurling events that investigators have little or no control over. Harrington (2002) seconds this motion and takes it a step further. Case studies are what the doctor ordered when theory and/or the empirical evidence base are weak, and new perspectives and serendipitous findings are necessary. In short, when working in a "messy" environment. As has been more than reasonably demonstrated, the situation in our specific work terrain more than justifies this approach.

Using units called "cases"(Swanborn, 1996), this approach focuses on understanding the dynamics within single settings. But it can also include multiple cases and numerous levels - micro, meso, and/or macro – of analysis (Yin, 1994). It typically combines such data collection methods as archives, interviews, questionnaires, and observations. The evidence may be qualitative (words) or quantitative (numbers), or both. Case study research aims at one or more of three targets: providing descriptions, testing theory, and/or generating theory.

Generating theory out of case studies has some definite advantages. According to Eisenhardt (1989b), the important strengths are: testability, the empirical validity that arises from intimate linkage with raw data, and the likelihood of generating novel theory. But there are also some definite disadvantages. One is that intensive use of empirical evidence can yield theory that is overly complex. A "stop confusing me with the facts syndrome". Another is that results could be too pinpointed and narrow - highly asset specific – and not sufficiently general.

Despite avowed disadvantages, Verschuren and Doorewaard (2001) support case studies for several reasons. One is that it is applicable in almost any conceivable situation, from explorative research to hypothesis testing. Nevertheless, if one wants to avoid being overwhelmed by data, the research questions in pioneering work should be couched in the broadest possible terms. It is also important to be flexible. Because start up questions and constructs are subject to changes during the course of the research.

But flexibility – what some may call go with the flow spontaneity – shouldn't be allowed to get out of hand. It must be kept on a short leash to maximize the four aspects of a good design: construct validity, internal validity, external validity and reliability (Section 5.3). Eisenhardt (1989b) recommends that a good balance can be achieved by both specifying *ex ante* some potentially important variables and avoiding premature (even rough) relationship- and conclusion-formulation.

Regarding the multiple case study approach, which is used here, the following can be said. The evidence from multiple cases is often more compelling, and the overall study is, therefore, considered more robust (Herriot and Firestone, 1983). But it also has drawbacks. It often requires time and resources far beyond the means of a single student or unsubsidized investigator.

My approach to this multiple-case study is illustrated in Figure 6 (slightly adapted from Yin, 1994, 49, and Hin, Bateman, and Moore, 1983).

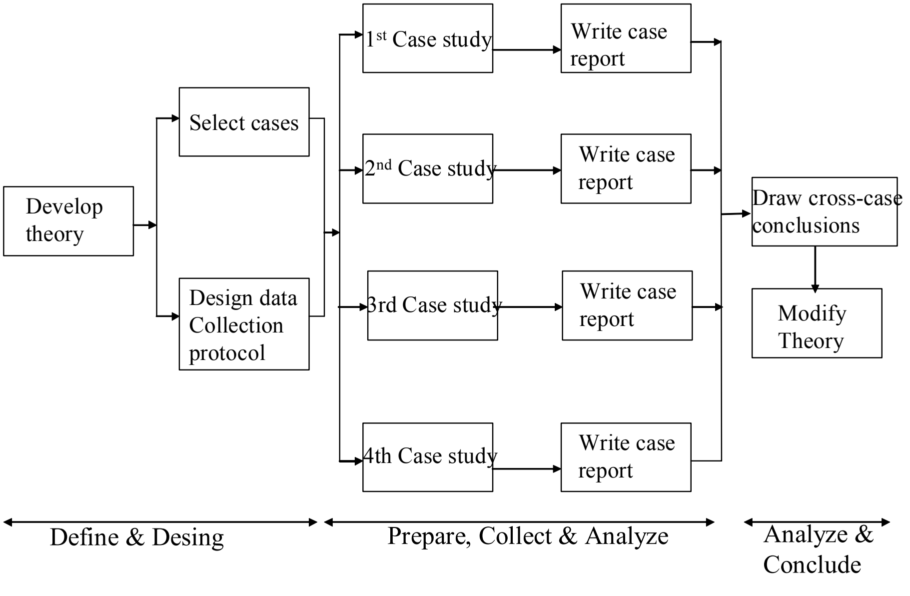

Figure 7: Multiple-case study method for this thesis

One remark needs to be made about this scheme. Although the four case studies were carried out in the same time frame (from March 2003 till April 2004) I was not completely able to eliminate the influence of any one or more interviews on the others. So there probably is some cross-breeding. Subsequent interviews and the study of documentation also could have had impacts. Therefore, the scheme is not as neat and straight forward as it appears in the diagram.

The four case study reports have been reviewed by the organizations and the promoters of this thesis. While they are not included in this chapter, they are available on request to interested professional readers. This chapter presents the results of the cross-case analysis.

Analyzing qualitative data within the context of – in this case – multiple case studies is a tough nut to crack. Miles and Huberman (1994, 2) eloquently stated:

> Yet, in the flurry of this activity, we should be mindful of some pervasive issues that have not gone away. These issues include the labor-intensiveness (and extensiveness over months or years) of data collection, frequent data overload, the distinct possibility of researcher bias, the time demands of processing and coding data, the adequacy of sampling when only a few cases can be managed, the generalizability of findings, the credibility and quality of conclusions, and their utility in the world of policy and action.

Harrison (Eds: Partington, 2002) noted that whether data is hard or soft, qualitative or quantitative, the case study researcher is faced with the challenge of dealing with complexity. Thus the general belief that case studies are easy to do is far from true. The most persuasive argument I can think of to convince those with lingering doubts on this subject is, "Try it yourself". The interpretation of results is more subject to the subjective arbitrariness of the researcher - "researcher bias" - than numerical analysis (Swanborn, 1996).

Eisenhardt (1989b) recommends what she calls "within-case analysis". While there is no standard format for such an analysis, this step is critical. It helps researchers to cope better with the huge and frequently unmanageable amounts of data involved in cross-case studies. By writing up a detailed case study, the researcher is forced to become intimately familiar with it as a stand-alone entity. Unique patterns begin to emerge, which in turn might help to accelerate cross-case comparisons. The overall tactics push researchers beyond initial impressions by using diverse, but structured, lenses on data. This improves the likeliness of accurate and reliable theory building, and increases the probability that the investigators will capture novel findings. I tend to agree with Eisenhardt. Patterns do emerge while analyzing cross-cases. But driving enriched theory from this analysis is yet another story.

Which case studies?

Eisenhardt (1989b) also advised the use of extreme or polar cases. "The goal of theoretical sampling is to choose cases that are likely to replicate or extend emergent theory. Theoretical sampling is most common, therefore choose diverse organizations." She also highlighted the importance of "population", because it defines the set of entities that the research sample is to be drawn from. According to her, random selection of cases is neither necessary nor desirable. Based on the notion of opposites and diversity I developed the following two by two framework. This created a need to do four case studies.

Table 5-1 Two by two framework used for selecting the case studies

	Public entities	Private companies
Non financial	Informatie Beheer Groep (IB Groep)	TPG NV
Financial	Bank Nederlandse Gemeenten (BNG)	ABN AMRO NV

From the perspective of Corporate Governance regulations, there is a clear distinction to be made between public and private entities. For the latter the codes discussed in Chapter 3 are not applicable. Further, the distinction between financial and non financial is also critical. The former operate in a far more regulated environment. Many laws, rules and codes apply to them and them alone, and they are more scrutinized by more regulators and supervisory bodies.

The choice of these four specific organizations was first and foremost based on their willingness to cooperate. This was supported by the Management Board and thus ensured positive assistance - "buy in" - at the highest levels. It also opened the doors to the archives – the historical record going back at least 10 years – which helped me see how things had changed over an, admittedly short, period. What's more, there were no visible constraints and pressures that would hamper the free flow of information and skew the results.

Other important selection criteria that were operative in all or some of the cases were:

- They should have an IAF, either in-house or outsourced.
- The private organizations should be operating in an environment where Corporate Governance regulations are applicable.
- I should have some prior knowledge of both the company and its environment so I could understand more rapidly the information coming in and be able to analyze it more thoroughly and sophisticatedly.
- A size large enough so it was likely to "suffer" from agency problems - Information Asymmetry - and, therefore, have supervisory bodies. For private companies this meant they had to be listed on the stock exchange. For semi-public entities – situated somewhere on the sometimes long and winding road between government and private enterprise – they had to be a Zelfstandig Bestuursorgaan (ZBO, an independent, self-supporting organization that used to be part of government) and have an independent Supervisory Board.
- I preferred "extreme" cases – opposites – in order to arrive at a better insight producing dynamic.

These criteria enabled me to delimit the domain (Swanborn, 1996). The next step was to select the organizations. The focus for the private companies was those listed on both the Amsterdam Stock Exchange (AEX) and the New York Stock Exchange (NYSE) because the latter would also be subject to more stringent American Corporate Governance regulations. The focus for public entities was considerably more limited, especially in the financial sector.

I approached 10 Dutch companies: 4 agreed to participate. But due to a chain reaction of external events and a pileup of bad and then worse news, which were expected to unduly muddy the waters, one of the private companies had to be dropped. This led to a successful search for another subject.

The number of case studies

There has been much debate among scholars regarding the appropriate number of case studies. On one side, there are those who say the more the merrier, as long as the benefits of an additional case - in terms of generalizability generation - outweigh the burdens of actually doing it (Swanborn, 1996). On the other, there is more than a whiff of scepticism about this more pain, more gain doctrine. "With multiple-case studies, does the issue of generalizability change? Essentially, no. We are generalizing from one case to the next on the basis of a match to the underlying theory, not to a larger universe." (Miles and Huberman, 1994, 29)

If I am reading this debate correctly, it hinges on the possibility - or lack thereof - of generalizing from cases. If the emphasis falls on the improbability of generalizing, we are immediately in scalding hot water. Because, as I noted at the beginning of this chapter, a major part of the justification for doing cases studies in the first place is to use them to generate new material, which can then be used to develop generalizations and theory.

Without pretending to have resolved this extremely interesting debate, I have opted to go with Horse # 1 and those who stress the advantages of multiple cases (Yin, 1994, 2003; Swanborn, 1996; Harrison, 2002; Eisenhardt, 1989b). Based on Swanborn's ideas (1996), looking for opposite poles is especially applicable for an explorative research study. In a later stage of the process, when the model is relatively fixed and predictions can be made about what will hold under what sorts of circumstances, predicted results can be set next to actual ones, compared and discussed. Yin (1994) calls this kind of tests "theoretical replication".

When was enough enough? Generally speaking, when to add more was trying to squeeze blood from stones and very few extra insights were gleaned from the exercise. Quantitatively speaking, four to ten cases usually works well. With less than four there is insufficient complexity for generating theory. Having to do ten is by no means something a single researcher can do within a reasonable time frame. So I decided on four.

Data collection

There is a link between case study choice and data collection methods and instruments.

Table 5-2 Design versus data collection: different units of analysis (Yin, 1994, 72)

	From an individual	From an organization
About an individual, if case study is an individual	- Individual behaviour - Individual attitudes - Individual perceptions	- Archival records
About an organization, if case study is an organization	- How organization operates - Why organization works	- Personnel policies - Organization outcomes

This study focused mainly on the lower left quadrant - about an organization, from an individual - and to some extent on the lower right - about an organization, from an organization. I used Yin's (1994) preferred approach and developed some tentative propositions about IA based on Agency Theory and Transaction Cost Economics. Those tentative propositions were used to guide the case studies and supported the development of questions and analysis.

I relied on the following sources.

a. Interviews with selected individuals (see below). In order to chart what had happened in the last decade, retired staff were interviewed in some cases.
b. Archival records, such as internet and intranet.
c. Documentation (see below): such public sources as annual reports, brochures, books, newspapers, and company documentation.

These choices were based on the fact that my research topics did not require any direct observations. The use of that would have caused me a considerable amount of pain without appreciable gain. For example, it could take up to two years to learn something that I could find out in a 20 minute interview.

For case studies, the most important use of documents is to corroborate and augment evidence from other sources. But while reviewing any document it is important to remember that it was written for some specific purpose and audience *other than* those of the case study.

Case study questions and interviews

With regard to case study questions, the following should be taken into account:

1) The questions are posed to the investigator, not the respondent.
2) Each question should be accompanied by a list of probable sources of evidence.

I developed a matrix that included the issues and questions and inventoried possible sources of evidence (interviews, archival records, etc.). I interviewed the following participants:

- I focused on Board Members of some regulators, mainly those involved with implementing regulations and recommendations in the financial services sector. For example, *De Nederlandsche Bank*, (DNB, The Dutch Central Bank), the *Autoriteit Financiële Markten* (AFM, the Dutch version of the Securities and Exchange Commission), and *De Pensioen- en Verzekeringskamer* (PVK, the regulator that supervises pension funds and insurance companies[71]).
- Some experts in the field of IA and Corporate Governance, both in the public and private domain, and a number of Supervisory Board/Audit Committee members not connected to the case study organizations.
- Within the case studies I interviewed:
    - The Chief Audit Executive (multiple times).
    - Board Members, mainly the Chief Executive Officer (CEO) or Chief Financial Officer (CFO) as being direct responsible for IAF. In some cases I also interviewed other members of the Management Board.
    - Supervisory Board members, in most cases the chairman of the Audit Committee and one or more other members of the Supervisory Board/Audit Committee.
    - The organization's external auditor.
    - The Corporate Controller or a similar functionary.
    - The Secretary to the Managing and Supervisory Board or the Legal Council. In many cases these functions are combined.
    - In a few exceptional cases I also interviewed managers below the Management Board level.

The aim of the interviews was to gather information pertaining to IA during the last 10 years. In order to facilitate preparation I drafted the issues I wanted to discuss - derived from the tentative propositions - and sent those to the interviewee together with an outline of my research. I also sent a short questionnaire to speed up the process of data gathering. Further, the preliminary questionnaire aimed at gathering information rather quickly and testing the usefulness and applicability of the survey. In some cases this questionnaire was returned prior to the interview. In many cases this was done afterwards. This format is much like the one described by Walsham and Waema (1993).

Respondents were interviewed for a short period of time - in many cases an hour, sometimes a little longer. The interviews were conducted in a conversational but semi-structured format, following the questions presented in Appendix 3. The scheme developed in Figure 2 (see Chapter 1) was used as a reference model to visualize the environment in which IA operates.

[71] At the time of finalizing this study, the DNB and PVK were merged into one regulator; DNB.

A summary of the interviews is listed below.

Table 5-3: Overview of interviews held

Organization	Number of interviews[72]	Functions of interviewees
ABN AMRO	11	Supervisory Board/Audit Committee members, Chief Financial Officer, Secretary to the Management Board, Chief Audit Executive and former Chief Audit Executive, external auditor, Senior Executive Vice President Finance
BNG	11	Supervisory Board/Audit Committee members, Executive Board members, Head and member of Organization and Information Management and Compliance, Acting Chief Audit Executive and newly appointed Chief Audit Executive, external auditor
IBG	11	Supervisory Board/Audit Committee member, Management Board, Secretary to the Management Board, Secretary to Supervisory Board/Audit Committee, Corporate Controller, Chief Audit Executive and former Chief Audit Executive, external auditor, Member Audit Department Ministry of OC&W, Head of Client Services Organization
TPG	9	Secretary to the Management Board, Secretary to the Supervisory Board/Audit Committee, Chief Audit Executive, external auditor, Corporate Controller, Chairman Disclosure Committee
Regulators	2	Board Members[73]
Total	**44**	

A major purpose of the interviews was to corroborate certain facts that were already established (not to ask about other topics of broader, open-ended nature) via documentation and archival records. Interviews in general should be considered verbal reports only. As such, they are subject to the common problems of bias, poor recall, and poor and inaccurate articulation. A reasonable approach is to corroborate interview data with information from other sources.

The interviews were recorded digitally and transcribed shortly after by an assistant. The transcripts were reviewed by me using the recordings before being sent on to the interviewees. They were asked to correct for errors or adjust whenever necessary. The final versions, after correction, were also sent to interviewees. In one or two cases, certain remarks were excluded from the historical record due to strict confidentiality, always on specific

[72] Some interviewees were interviewed more than once, especially the Chief Audit Executive.
[73] Those two interviewees were questioned around developments with regard to Internal Audit in general and not related to the case studies themselves.

request of the interviewee. The recordings were available for review by the promoters and include the excluded remarks. Last but not least, the final version of Chapter 5 was also presented to the case study organizations for their approval.

There are three principles for data collection (Yin, 1994) that were taken into account.

1. Multiple sources of evidence;
2. Creating a case study data base; and
3. Maintaining a chain of evidence.

With regard to those three principles I used multiple sources of evidence. This so-called triangulation, discussed by Patton (1987), includes:

1) Data sources (data triangulation);
2) Different evaluators (investigator triangulation);
3) Perspectives on the same data set (theory triangulation); and
4) Methods (methodological triangulation).

Denzin (1978, 291) broadly defined triangulation as the "combination of methodologies in the study of the same phenomenon". Jick (1979, 604) wrote:

In all the various triangulation designs one basic assumption is buried. The effectiveness of triangulation rests on the premise that the weaknesses in each single method will be compensated by the counter–balancing strengths of another.

The case studies in my research were developed in such a way that data triangulation is secured. Investigator triangulation is not. However, the promoters have pushed the investigator by both questioning his material and also taking a closer look at it themselves.Theory triangulation is possible only to a limited extent because but the data has been analyzed using different theories. Methodological triangulation has been provided for, using not only the case study approach but also a survey (in that order). Jick noted (1979, 606):

> It should be underscored that the quantitative results were used largely to supplement the qualitative data, rather than the reverse…. Triangulation in this respect can lead to a prominent role for qualitative evidence (just as it should assure a continuing role for quantitative data).

Jick (1979, 610) hastened to say that triangulation may very well be a strategy that is not suitable for all research projects. Eisenhardt (1989) also pointed out that multiple data collection methods are essential for triangulation. This provides a stronger substantiation of constructs and hypotheses.

According to Yin (1994), every case study project should have a formal database so that, in principle, other investigators can directly review the evidence and not be limited to written reports. A case study database increases the reliability of the entire case study.

For my research I used the database possibilities provided by Lotus Notes. This platform enabled easy access and retrieval via search engines as well as predefined access trees. A back up copy of the material is available on my own personal computer. The only problem is that hard copies are not to be found in the database. Although much of the material is available in electronic versions and accessible via Lotus Notes, some of it remains in hard copy files, kept in my office. Access is possible because a bibliography is drafted for each case study.

This principle of maintaining a chain of evidence is followed to increase reliability. It allows external observers – for example, readers of the case studies - to follow the trajectory of any evidence from initial research questions to the ultimate case study conclusions.

During the case studies many documents were gathered and analyzed. Those included: articles of association; charters of the IA and Audit Committee; minutes of meetings of the Supervisory Board/Audit Committee, Management Board, IA, and Disclosure Committee; manuals; audit reports; audit planning; codes of conduct; agendas; intranet and internet websites; annual reports; management letters from the external auditor; correspondence with the Tabaksblat Committee; memos and letters pertaining to IA; correspondence with supervisory bodies, such as DNB and PVK; risk profiles; training programs; benchmark data, e.g., the Global Auditor Information Network (GAIN) from the IIA Inc.; study reports; compliance reports; papers by staff members; articles and bylaws; quality reviews; correspondence with Parliament; minutes of meetings of Parliament; reports of the Court of Auditors; reports of external auditors; financial reports; business plans; Corporate Governance reports; auditor independence policies; visitation reports; SWOT analyses; and mission statements.

Secondary sources were articles in journals or newspapers and publicly available data, such as information gathered through the Chamber of Commerce.

The reason for studying the archival materials was to triangulate the data. That is to check and corroborate information stemming from interviews and other sources.

Case study protocol

According to Yin (1994), this is essential to have when using a multiple case study design. The protocol is a major tactic in increasing the reliability of the case study. It should contain:

- ❖ An overview of the case study project: project objectives and auspices, study issues and relevant readings about the topic being investigated.
- ❖ Field procedures: credentials and access to the case study sites, general sources of information, and procedural reminders.
- ❖ Case study questions: specific questions that the investigator must keep in mind when collecting data and potential sources of information answering each question.
- ❖ A guide for the case study report: outline, format for the narrative, and the specification of any bibliographical information and other documentation.

The case study objectives were aimed at:

- ❖ Exploring whether the tentative propositions were validated and theoretical implications were justified in practice by relating the findings of the case study to the theories studied.
- ❖ Providing supportive data for developing the survey.
- ❖ Enriching theory with regard to Internal Audit.
- ❖ Getting a clear picture of the IAF in each case study, its development and current status.

- ❖ Providing data for analyzing the relationship between Corporate Governance recommendations and regulations and changes in IA over the past decade.
- ❖ Getting access to the views of the different participants and their opinions about this relationship in order to be able to triangulate and cross analyze the data within a single case study.
- ❖ Using a format that enables cross analysis among the different case studies.

A case study protocol was drafted and each case study was finalized with a case study report that was sent to the organizations to be approved and – if necessary – corrected. The case studies were held between April 2003 and March 2004 and covered the developments during the last decade prior to 2003.

The case study reports had the following content:

1. Introduction to the case study and company
2. Brief history of the company
3. Company strategy
4. Organizational context and structure
5. Culture and guiding principles
6. Its IA
7. Addressing the research questions
8. Conclusions
9. Appendices
    - i. Organizational data
    - ii. Organizational structure
    - iii. List of interviewees
    - iv. Documentation
    - v. Used Questionnaires Used
    - vi. Other

The results of the case studies were compared with the tentative conclusions drafted after researching the relevant literature (see Chapter 4).

Criteria for judging the quality of research design

There are four logical tests that are commonly used to establish the quality of any empirical social research. These, which are also relevant to case study research, are shown in the following table (Yin, 1994).

Table 5-4 Criteria for assessing the quality of the research design (Yin, 1994)

Tests	Case study tactic	Phase in research in which tactic occurs
Construct validity	- use of multiple sources of evidence	- data collection
	- establish chain of evidence	- data collection
	- have key informants review draft case study report	- composition
Internal validity	- do pattern-matching	- data analysis
	- do explanation building	- data analysis
	- do time-series analysis	- data analysis
External validity	- use replication logic in multiple-case studies	- research design
Reliability	- use case study protocol	- data collection
	- develop case study database	- data collection

Construct validity

Construct validity is needed to establish correct operational measures for the concepts being studied. This test is especially problematic in case study research. Critics point out that many case study investigators fail to develop a sufficiently operational set of measures and that "subjective" measures are used to collect data. Churchill (1979, 66) developed a framework for developing better measures and constructs. The purpose of his framework is to enhance both construct validity and reliability. One should keep in mind that Churchill developed this framework in the realm of marketing research where large quantities of data are gathered via a survey methodology. In my approach, I started with the case studies and statistical measures, such as coefficient alpha. While factor analysis did not apply here, it was used in the survey (see Chapter 6).

I focused on the following tactics: using multiple sources of evidence; establishing chains of evidence; and having key informants review the draft case study report.

Internal validity

Internal validity is only relevant for explanatory and causal studies and not for descriptive and exploratory studies. Since this research is descriptive and exploratory, it does not apply here.

External validity

External validity establishes the domain to which the studies findings can be generalized. This test deals with the problem of knowing whether the study findings could become generalizations beyond the immediate case study. Generalization is not automatic and, therefore, the theory must be tested through replications of the findings in a second or even a third case, where theory has predicted that the same results should occur. Then there is at least a *prima facie* case for accepting them in a much larger number of similar cases. Or at least considering them as a worthwhile *point de départ* to either test or refute. This is called *replication logic*. I used the multiple case study approach described above to foster external validity.

Reliability

Reliability demonstrates that the way a study was conducted - for example, data collection procedures - can be repeated and will produce approximately the same results and conclusions. The role of reliability is to minimize errors and biases in a study. I developed a case study protocol and used the case study database approach to meet the needs for reliability.

5.3 Short description of case study companies

ABN AMRO

ABN AMRO is the stock exchange listed banking organization of ABN AMRO Holding N.V., which operates almost exclusively through ABN AMRO Bank N.V., or one of the numerous subsidiaries of ABN AMRO Bank. Measured by key capital, it is the 8th largest European bank and 13th in the world rankings. At the end of 2003 it had over 3,000 offices in 67 countries and territories and approximately 112,000 employees. The balance total amounted to EUR (€) 560 billion. Its main activities are banking, investment management, and leasing. It distinguishes three broad customer segments.

- Consumer & Commercial Clients: the daily banking of about 15 million private clients and relations with small- and medium-sized businesses. The home markets are The Netherlands, the United States (Midwest), and Brazil.
- Wholesale Clients: large international organizations and institutions. With about 10,000 clients, 20,200 employees, and activities in more than 45 countries, this unit is among the largest in Europe.
- Private Clients and Asset Management: for wealthy private clients and institutional investors. This fast growing division of the organization has a strong position in numerous markets.

ABN AMRO has an 11 member Supervisory Board, 6 of whom constitute the Audit Committee. As already mentioned in Chapter 3, organizations in the financial sector in The Netherlands are required to have an Audit Committee. Audit Committee meetings include other participants, such as the Chief Financial Officer (CFO) and, if deemed necessary, others, like the Chief Audit Executive (Chief Audit Executive) and/or the external auditor.

In a memorandum dated March 24, 2003[74], the bank re-drafted its governance structure and elaborated on the Audit Committee's mandate. One of its duties is to regularly review and discuss "the internal auditor function, the Company's group audit charter, and the organization + control mechanisms". The Audit Committee may authorize or conduct investigations into any matter falling under the scope of its responsibilities.

[74] Memorandum on the Governance of the Supervisory Board of ABN AMRO Holding NV, March 24, 2003.

Informatie Beheer Groep (IB Groep)

The Informatie Beheer Groep (IB Groep) is a *Zelfstandig Bestuursorgaan* (ZBO) based in Groningen. A ZBO is an independent, self-supporting organization that used to be part of government. In this case it was semi-privatized in 1994. In other words, it is kept at arm's length from government and to some extent subject to market conditions. IB Groep employs about 1500 people.

IB Groep operates at the behest of the Dutch Ministry of Education, Culture, and Science and is responsible for the processes of application, selection, and placement of higher education. It collects tuitions, issues study loans, grants and student public transportation cards, and controls numerous education-related registrations. It is also responsible for the organization of state and school exams. The 2003 annual budget for these programs was about € 3.7 billion. Its annual turnover was about € 130 million.

The Dutch Ministry of Education, Culture, and Science directs the IB Groep - at arm's length of course. The Minister appoints the 7-members of its *Raad van Toezicht* (Oversight Committee). It meets four times per year and functions as both its Supervisory Board and Audit Committee. As a monopolist active in a publicly sensitive function, the IB Groep is also subject to numerous other external supervisors. The most important ones are the *Algemene Rekenkamer* (the government's Court of Auditors) and the audit departments of both its "house" Ministry and the Ministry of Finance.

A performance contract is renegotiated each year between the Ministry and IB Groep. It stipulates the goals to be achieved and the resources necessary to accomplish that. There is a meeting every 4 months to review the agreed-on indicators, and a situation update report is issued. This report also includes all the recommendations and actions from audit reports of the external accountant (not auditor), the internal accountant, the Ministry, and sometimes from other sources as well.

N.V. Bank Nederlandse Gemeenten (BNG)

N.V. Bank Nederlandse Gemeenten (BNG), located in The Hague, has about 400 employees. It was founded in 1914 on the initiative of the Association of Dutch Municipalities. Its *raison d'être* was primarily to supply the public sector with the most advantageous loans. Since 1922, it has become a fully government-owned enterprise (50% Dutch central government, 50% local governments). It acts as the principal Dutch public sector financial agency by, for example, handling monetary transactions between the central government and municipalities.

BNG's main clients are government and institutions that are active in such areas as housing (associations), health care, education, and public utilities. But lending is limited to central and local governments, state-owned entities and state-guaranteed institutions. Lending to borrowers outside BNG's core Dutch public sector business is further restricted by the articles of association. Profit maximization is not the main driver.

At the time of the case studies BNG had an 11-member Supervisory Board (decreased to 10 in 2005) and a 4-member Audit Committee (decreased to 3 in 2005). The latter's meetings include members of its Management Board (which it calls its Executive Board), the Chief Audit Executive, and external auditor. Since BNG is a bank and under the jurisdiction of DNB, the Audit Committee is obligatory.

TPG

TPG is the holding company of Koninklijke TPG Post (the Royal Mail) and TNT. It takes care of the strategic vision and finances that those two companies require to maintain and extend their market positions within mail, express, and logistics. TPG operates worldwide, and at the end of 2003 had 160,000 employees in about 70 countries, providing services in about 200 countries. It is the world's first fully privatized company originating from the public mail sector. In 2003 it ranked third for the fourth year in a row in the category mail, packet, and transport industry of the *Fortune* 500's "World's most admired organizations".

Koninklijke TPG Post (nowadays called TNT) is the main mail service provider in The Netherlands and a market leader in international business mail. It has three divisions: Mail, Express and Logistics. The Mail division collects, sorts, transports and delivers letters, printed matter and packages, addressed and non-addressed mail, domestically and internationally. It also offers services in data- and document-management - such as direct and interactive marketing - and for managing physical and electronic information flows.

The Express division takes care of the door-to-door transport of documents, packages and freight with guaranteed delivery at a very specific time and day, and provides regional, national and worldwide express services (mainly under the brand name TNT).

The Logistics division goes further than transport and storage. It also designs, implements, and monitors complex delivery chains, and uses the most advanced technologies to guarantee optimal transparency and full integration of the complete logistical process. The delivered services depend on specific customer needs. In other words, they are custom-designed.TNT is a major logistics provider in the automobile, electronics and pharmaceutical sectors.

TPG's Supervisory Board has a minimum of 7 and a maximum of 12 members (8 at the time of the study). In December 2003 the Supervisory Board approved the revision of the Audit Committee Charter, which was adjusted to be in compliance with the US' Sarbanes-Oxley Act. The Audit Committee meets at least once per quarter and more than that when they deem it necessary. The Audit Committee decides if and when the CEO, CFO, external auditor and/or Chief Audit Executive attend these meetings.

5.4 Case study results[75]

The following scheme was introduced in Chapter 1 and will be followed to facilitate comprehension of the case study results.

1. **Role**: This includes IA's contribution to the organization – why it was established and its license to operate - and how this is fulfilled. What people work there? Staff or outside workers? Or a combination of both? Make or buy is included in this section as well.
2. **Position**: This includes IA's organizational position and size. In other words, who is it responsible to – who calls the shots. Who hires and fires, rewards and punishes it. How IA is monitored and controlled.
3. **Scope of services**: This includes what is included in IA's scope of services and its relationship with the external auditor.

[75] The case studies were executed from March 2003 till April 2004. Changes after finalizing the case studies were not taken into account.

5.4.1 Role

In all of the case studies and among everyone interviewed - Supervisory Board/Audit Committee and Management Board members, company officers and, Chief Audit Executives - there is a strong belief that there should be an IAF. This is not surprising for at least three reasons. One, each organization has a long history with IA. Two, if they didn't feel that way, it is hardly likely that they would have agreed to participate in this research. Three, I wouldn't be interested in them either. Thus bias has to be assumed.

In the eyes of all interviewees, IA adds real value. The next obvious questions are: what exactly is this added value? What is it made of? Where is it located? What is gained by it being there? What would be missed if it weren't? And how much - even an approximation - value is added? And if not all of those questioned have been answered - and might not even be answerable - why is the belief so unanimous and strong?

When asking why an in-house IA was necessary, I received a number of responses listed in the table below. I've added columns Agency Theory and Transaction Cost Economics and added X's where those responses seem to be aligned with the research results found in those theories. If an ? is added the alignment is rather weak and inconclusive. If it is Not Applicable, NA is added.

Table 5-5 Why Have IA?: Case Study Results Compared With Tentative Conclusions From Theory (Agency Theory and Transaction Cost Economics)

Nr	Response	Agency Theory	Transaction Cost Economics
1	The complexity of the organization makes it difficult to break in fast.	X?	X
2	In order to understand the culture of the organization, it is essential to be there and "one of us".	NA	X
3	Knowledge of the company is crucial and an in-house staff is better able to generate the necessary information.	X	X
4	The organization needs to have IA available on a permanent basis.	NA	NA
5	The frequency of audits is high.	X?	X
6	An in-house IA contributes to the robustness of the organization.	NA	X?
7	An in-house IA makes it possible to transfer knowledge and best practices throughout the organization.	NA	X
8	IA is a management breeding ground option.	NA	NA
9	In cases of malpractice, the possibility of issuing a liability claim (against third parties) is not an issue. Neither the Management Board or the Supervisory Board/Audit Committee regards this as an essential criterion.	X?	NA
10	An outsourced IA would be more expensive.	X	NA
11	Regulations in the financial sector prohibit an outsourced IA as long as it is economically feasible to have it in-house.	NA	NA

Before elaborating on these responses in relation to theory it needs to be made clear that these responses are only those expressed by the interviewees in the case studies and, therefore, far from complete. It is evident that if the number of interviewees had been larger other responses would probably have come up. Nevertheless, it provides some insight into the matter of IA's license to operate in at least four distinct organizations.

Now let us take a closer look at the list. Response 1 seems to be aligned with both theories. But some interpretation is needed. From an Agency Theory perspective one might conclude that a slow uptake of relevant information might be due to a high level of Information Asymmetry, which the auditor himself is also subject to. I've added a question mark because I doubt whether this conclusion is justified. From a Transaction Cost Economics perspective it's more conclusive, because complexity is linked Asset Specificity. The higher the degree of Asset Specificity the more difficult it will be to break in fast and understand what is happening.

Response 2 is even more related to Transaction Cost Economics. It is the by now classic "one-of-us" notion, which perfectly mirrors Williamson's remarks in Chapter 4. No relation can be found with Agency Theory.

Response 3 is consonant with both Agency Theory and Transaction Cost Economics. It is about Information Asymmetry (Agency Theory) and being one of us and might also relate to Asset Specificity (Transaction Cost Economics).

Response 4 is not correlated with either of the two theories. The response shows a general belief that IA is necessary. If delved into, which I didn't, it could very well get attached to one of more of the other responses.

Response 5 (frequency) is also related to Transaction Cost Economics – as one of the founding attributes. The need for audits will lead to an increased frequency of audits. In this particular case study it was used as an argument to have IA in-house. As the number of audits increases outsourcing tends to equal and exceed the costs of having it in-house and, so to speak, on tap. In some respect it might also be related to the Agency Theory's Information Asymmetry. If this is high. there might be a need to increase the number of audits.

Responses 6 and 7 are about the possibilities of using audits to transfer knowledge and best practices throughout the organization. Williamson also made an argument about Asset Specificity in the sense of specific knowledge needed to conclude transactions. The higher the level of Asset Specificity the more difficult it will be for auditors and managers to assess what is going on and come to grips with what needs to be done. Thus audits can support and sustain the spreading of best practices and thereby contribute to the robustness of the organization.

Response 8 (breeding ground concept) does not easily tie into either Agency Theory or Transaction Cost Economics.

Response 9 contradicts what Agency Theory predicts, at least according to Caplan and Kirschenheiter (see Chapter 4).Their model predicted that if risks of not discovering control errors in a timely fashion increased, outsourcing would be preferable. Because it would then be possible to shift blame and financial responsibility to third parties when liability claims started hitting the fan.

By contrast, response 10, an outsourced IA is more expensive, is supported by the research of Caplan and Kirschenheiter. Although they used a model – and not empirical data – they've demonstrated that the general preconception that an in-sourced IA is cheaper (and consequently an outsourced IA being more expensive) is supported.

Response 11, regulators requiring financial organizations to have an in-sourced IA is not directly related to either Agency Theory or Transaction Cost Economics.

Occasionally, it is the strong belief of the man at the top that heavily affects the issue of IA's rationale. Although all four companies had a long history with IA - an embedded IA, so to speak - IB Groep acknowledged that IA's rationale and role was heavily impacted by a newly appointed Chairman of the Management Board after a severe case of fraud.

The following scores were derived from the answers to the questionnaire in Appendix 4. Scoring was done on a scale of one to five, from strongly disagree (1) to strongly agree (5). The numbers were added up and divided by the number of respondents, providing the percentages shown in the table (e.g., five questions have a maximum score of 25 (5 times 5) and if the score of 4 respondents was 20 in total, then the percentage was 20/25 = 80%). For example, the higher the number the higher the degree of Asset Specificity and or Information Asymmetry will be.

Table 5-6 Scores on Transaction Cost Economics and Agency Theory Attributes

Scores on Transaction Cost Economics and Agency Theory in percentage of maximum possible score	ABN AMRO	BNG	TPG	IB GROEP
Transaction Cost Economics				
Asset Specificity	82	62	73	67
Uncertainty	64	49	55	67
Frequency	68	65	60	68
Agency Theory				
Information Asymmetry	43	45	53	48

This table demonstrates, more or less as a byproduct, that Asset Specificity shows more distinct and conclusive evidence than Uncertainty (most certainly) and to a lesser extent Frequency. Much research – as shown in Chapter 4 – has already acknowledged that Asset Specificity is indeed the most telling attribute of Transaction Cost Economics.

Taking a closer look at the Agency Theory and Transaction Cost Economics scores the following results were gathered. None of the case studies showed a high degree of Information Asymmetry. The scores were: ABN AMRO 43; BNG 45; TPG 53; and IB Groep 48 (out of a possible total of 100%).

This is odd for at least two reasons. One, because the significant differences in company sizes – number of employees ranging from 400 to 160,000 - seems to warrant that there would be substantial variations in Information Asymmetry ("hidden information"). Two, because according to Agency Theory, larger companies operating globally and with such diversified services (ABN AMRO and TPG) should suffer more from it than smaller ones (IB Groep and BNG). So why didn't they?

The simple explanation might be that all those interviewed were high ranking officers with a long history within their respective organizations, who had worked their way up the ranks. Thus they were particularly well placed to have a panoramic view of what was happening, no matter where they were located now. Further, they were at the center of the information flow within the organization and quite heavily involved in business planning, decision-making and reporting and might, therefore, have developed a thorough understanding of the business and lower level management. Another reason might be that, while they may be aware of the pitfalls of Information Asymmetry, they don't believe they suffer from it.

From a Transaction Cost Economics perspective the data was more compelling and predictive. All four case studies showed high scores on Asset Specificity. The scores were: ABN AMRO 82; IB Groep 67; BNG 62; and TPG 73. Thus it might not be surprising that they all consider an in-house IA essential. All of the companies have been long time committed to having an IA and none had ever even considered the make or buy question, let alone pondered deeply over it. While Corporate Governance regulations are not the main drivers for having IA, all parties do acknowledge that the rationale is at least strengthened by them.

But a number of caveats should be taken into account regarding all these scores. First, the number of respondents was deliberately limited (three per company). Second, as already mentioned, they were all high ranked officers with a long time career in the companies and a good panoramic view. Third, while the questionnaire was developed using prior questionnaires from Widener and Selto (1999), one might, nevertheless, challenge the "accuracy" of the questions posed. Transaction Cost Economics elements are not easily captured in plain terminology, and interpretations of whether or not they are decisive factors might be just that. Interpretations based on the bias of either the interviewer (myself) or the interviewees. Or both.

The degree of Information Asymmetry (Paape et al, 2005, 283) is even more difficult to grasp via a questionnaire[76]. One of the reasons for this is that little research has been done to actually measure it within organizations. Thus how to do it and what Information Asymmetry does and does not consist of and entail is a hit and miss affair, and subjective in the extreme. Since there has been little quantitative research on this topic, there are no established yardsticks - even approximate ranges - to help us determine what is high, low or normal. Three, Information Asymmetry is almost by definition a hazy area. In order to begin to approach it, you have to ask at least two separate people the same sets of questions. For example, the principal and the agent about, say, what the agent is supposed to do, and what he is actually doing. Then you would have to work out a separate methodology for comparing the results and calculating the asymmetry, which sounds to me like a whole separate thesis. How these kinds of issues have been approximately dealt with in this thesis will be discussed in the next Chapter.

On the positive, more hopeful side, however, it was noted that the scores were very similar among the different respondents within the companies. The spread was very low, not only

[76] Information asymmetry in theory is normally defined via the perspective 'outsider' versus 'insider' using proxies such as R&D expenditures, 'bid-spread' at the stock exchange, etc. Defining it from the perspective of the Board versus lower level management in organizations has never been done. Appendix 3 shows the questions that were used to come up with a measure for Information Asymmetry.

between the companies, but also among respondents. Further, there was some circumstantial evidence about the applicability of Information Asymmetry, because questions along those lines did not raise eyebrows and elicit questions as to what was meant by certain questions.

A last remark needs to be made regarding the make or buy issue. Among my respondents and elsewhere as well, there is a general belief that an external party is an occasional inconvenience, someone to be suffered rather than preferred. And the most obvious candidate for that reference has always been the external auditor. Nowadays, Corporate Governance regulations, like Sarbanes-Oxley, prevent the external auditor from providing IA services. And while Sarbanes-Oxley is not applicable to all organizations, there is a tendency to adopt it in companies that fall outside its jurisdiction.

If presented with the possibility that a third party could become semi-permanent fixture or even be organized as a dedicated team, the response was even less than enthusiastic. For one thing, the respondents thought, the costs would be too high. For another, the outsider could not acquire an intimate understanding of the culture, which, the respondents thought essential for a proper functioning.

5.4.2 IA's Position

Centralization is the prevailing theme

With regard to IA's organizational position, three out of the four cases have a history of significant changes. Those are IB Groep, TPG and ABN AMRO. Essentially, the before story was IA, or parts of it, was decentralized and subject to lower, division-level management. The after story was centralization and being brought under the umbrella of top management.

The changes were most profound within IB Groep. Between 1995 and 2001 both the Supervisory Board and Management Board uniquely demonstrated limited interest in its activities and did not place it high on their agendas. IA was a decentralized function focusing on assuring the reliability of financial data and ascertaining compliance with relevant regulations. Then a fraud, which had been on going for several years, was discovered in 2002. That and the appointment of a new managing director in 2001 were responsible for some major changes. The IA was shifted from the Corporate Control Function, where it had been placed in 1997, and centralized under Corporate Staff. It was made a separately positioned department. A new Chief Audit Executive was appointed in October 2002.

Part of the decentralized before story was the belief that IA assignments could be best performed close to the operations. The 1997 shift to Control was based on trying to achieve synergy between audit and control. But those synergies were never realized. In cases of conflicting interests in Control and Audit, Control, not surprisingly, always won. And then, with the fraud, everything changed dramatically.

According to those interviewed, maximizing IA independence and impartiality were among the reasons for separating it from Controlling and centralizing it. Since then, the IA's position has been strengthened. This can be deduced from the appointment of a new Chief Audit Executive and the establishment of an Audit Committee as part of the Supervisory Board. Previously, the Audit Committee was staffed with internal officers only. What's more, the number of Internal Audit staff increased from 8 to 11.

Within TPG the IA story is considerably more confusing. The before story was there were two separate IA's. One, a 10-member staff at headquarters, which reported to the CFO. Another 40-member staff at KPN, which reported to the Divisional Finance Director. The scope of services was focused mainly on financial and compliance audits. Some quality assessments (ISO/EFQM) were covered. Among the Management Board and the Supervisory Board/Audit Committee there was no perceived value added, and the primary aim was to save money on external auditor (which was provided by PricewaterhouseCoopers). The average age of auditors was over 40 and the educational standards were not up to contemporary speed. Many were long time career auditors without professional qualifications. There was no link with the Audit Committee.

After its de-merger from KPN in 1998, TPG became a separately listed company. In 2000 the company created the three divisions mentioned earlier - Mail, Express, and Logistics - and its Corporate Audit Services (CAS) inventoried its own structure and position. The new Chief Audit Executive, appointed in 1999, decided it was time for a major transformation. The IA was decentralized and each main division was supposed to have its own. CAS was to have functional responsibility for the decentralized IA's. But the administrative side was to be handled by Divisional Management. While the Mail Division, which already had an IA, bought in pretty quickly, the other two did not. In fact, they didn't have an IA and it took a lot of persuasion to convince them that they actually needed such a thing. Once that happened, Express turned around fairly rapidly - they aren't called "Express" for nothing – and welcomed IA. For Logistics the same process took about two years.

This decentralized structure had a few downsides. One was that divisional management not only picked up the tab for IA, but also controlled it. The Chief Audit Executive needed to make sure that audit plans were executed and, if altered, that it was in the best interest of TPG as a whole. Fierce discussions ensued when it was necessary to redirect audit resources to other divisions. The divisional management's reasoning was pretty basic, and comprehensible within its strictly limited context. "We have our own interests and needs. Why should we cut back on them? After all, we're footing the bills." This situation quite often created conflicts of loyalty.

The argument for decentralization, which was based partially on the Management Board wanting a lean and mean headquarters, was becoming increasingly wobblier. At the same time the argument for centralization was becoming stronger. Part of the logic was driven by efficiency concerns within the organization. Centralization was the best way to unify operations, optimize resources and maximize the coordination and performance of approved audit plans. Transparency would go up a notch. Another driver was the tightening noose of Corporate Governance regulations and "strong" recommendations in the US and Europe, which required TPG to demonstrate the adequacy of its internal control system and sign off on that.

Thus the divisional IA's were integrated into the central CAS system by the end of 2003. CAS now has two distinct subsets. One for the national and another for the international side of the business.

The story for ABN AMRO is less jarring. Group Audit was centralized from the start in 1992. In 2000 three Strategic Business Units (Supervisory BoardU's) were created. Each Supervisory BoardU would be self-supporting and have its own IA. While the Chief Audit Executive did not support this move and the Audit Committee positively objected to it, the decision makers rammed it through. Supervisory BoardU's got their own IA. Provisions and constraints were drafted. One of those was that the quality of the work and the actual audit planning should not be hampered by local management, and if that happened, Group Audit would re-perform some of the work.

The Chief Audit Executive concluded within 6 months that due to breaches of the provisions he was becoming a trouble-shooter, constantly overlooking the actions of local audit staff. Soon thereafter it was decided that decentralized audit functions would once again be hierarchically subjected to Group Audit. Yet due to difference of opinion between the Head of Audit Inspection of Business Unit The Netherlands and the Chief Audit Executive one stand alone IA remained. At the end of 2003 a new initiative was taken to integrate this last separate audit unit with Group Audit.

The number of staff was 300 for Audit Inspection. This number had to drop by 33% to 200. The grand total for Group Audit by then is some 750.

The independence issue rears its head: who's in charge?

IA's position inside the organization is deeply entangled with independence and objectivity issues. Independence is defined as freedom from material conflicts that threaten objectivity and objectivity is defined as freedom from bias (IIA Inc., 2001b). The stand of the IIA Inc. is that organizational position is a determining factor for independence, which in turn fosters objectivity. As shown in Chapter 2, external auditors tend to judge the level of IA independence based on organizational position and reporting lines.

In that same chapter, we discovered that independence and objectivity are relative in nature. But while the degree of independence may be enhanced by IA's organizational position, it does not guarantee it. And it certainly doesn't guarantee it to the extent that we can use the word "independence" as a stand alone semi-noun. The Chief Audit Executive's I interviewed are within the organization and are currently responsible to, and compensated by, the Management Board. But things don't change all that much even when he is outsourced. The Management Board pays his fees in those cases as well. And as I have had more than one occasion to note, he who pays the piper calls the tune. Thus, as long at IA is in the hands of the Management Board, it can never be independent of it and objective about it.

The question then arises whether IA's overall independence and objectivity will be enhanced if its organizational position is altered. If so, what will be the best level to report to? In Agency Theory terms, IA is bound to be the agent of some principal. The question is, which one? And that is also the question for us here. At what reporting level in the organization is IA independence and objectivity maximized?

While the tendency in Corporate Governance regulations is to place the responsibility for supervising both Internal Audit and external auditor in the hands of the Audit Committee – in the one-tier environment and to some extent also in the two-tier - this is not at all subscribed to in the four case study companies. While there was general agreement (with one exception) that IA independence would be greatly benefited by the Chief Audit Executive reporting to the Supervisory Board/Audit Committee and be present at Audit Committee meetings when audit issues were being discussed, it was considered not done to even suggest that IA would not remain subject to the Management Board.

When asked whether this might create a "serving two masters" scenario, the answers varied. The bottom line was that the answers very much depended on who was being asked. Not surprisingly, all the Chief Audit Executive's recognized the slipperiness of the situation. One, who for obvious reasons wishes to remain anonymous, described his approach to the "challenge" with graphic eloquence.

> Whenever I am directly addressed by the Audit Committee in a meeting I constantly look while answering from the corner of my eyes to see the reaction of the Management Board members present.

Having said that, it is important to add that many of the Chief Audit Executive's noted it was a "doable" dilemma. For example, the Chief Audit Executive at TPG said he always reports first to the Management Board, and wouldn't dream of bypassing it. He said that if and when the Audit Committee became responsible for CAS, TPG's version of IA, it would enhance independence. But it would do so at the cost of being internal. As far as the rest of the company was concerned, CAS would become a *de facto* external auditor. Since he believes this wouldn't benefit anyone – including CAS itself – it should be avoided.

Other interviewees, equally unsurprisingly, tended to minimize the "challenge". Yes, to a certain extent, there might be some cause for discomfort and concern. But they certainly weren't grave, and any well educated Chief Audit Executive could easily juggle any possible embarrassments. By delegating the responsibility – passing the buck – for the problem to the Chief Audit Executive, they are effectively trying to wash their hands of it and, as we say in Dutch, think it away (*wegdenken*).

Within the IB Groep, all parties agree that the Chief Audit Executive should be present in Supervisory Board and Audit Committee meetings when IA reports and plans are being discussed. That promotes direct contact between IA and supervisors and contributes to the assurance the Supervisory Board/Audit Committee need. But up until now there have not been any direct meetings between the Chief Audit Executive and the Supervisory Board/Audit Committee. This might be explained by the fact that the Audit Committee only recently (2003) came into existence.

At ABN AMRO, independence and objectivity are, according to its Audit Charter, essential to IA's effectiveness. How is this achieved? Even though the Charter indicates knowledge of "contemporary opinions of authoritative supervisory bodies and commissions throughout the world [that] also dictate the highest possible independence of the IAF as well as the Audit Committee", their answer is not by subjecting it to the Supervisory Board/Audit Committee, but, rather, to the Management Board. The Chief Audit Executive has a primary responsibility to two chairmen: that of the Management Board and the Supervisory Board/Audit Committee. He must report his findings to the former "with discretion". It doesn't say how he is supposed to report to the latter.

ABN AMRO'S Chief Audit Executive is fully responsible for an adequate, organization-wide execution of the IA. For managerial issues he reports to the corporate CFO, who is himself a manager. The same CFO, who in consultation with the CEO, appraises and pays him. It is clear that this situation might somehow affect his independence and objectivity.

To somehow offset the imbalance and help assert the authority of Group Audit, the Charter allows IA to initiate an escalation procedure. The extent of the escalation is determined by the seriousness of the case. Since the Charter does not specify how to determine the level of the case's seriousness, this is left to the Chief Audit Executive's discretion. At first glance, that seems to be highly empowering. It is. But it comes with some downsides. When initiating escalation procedures he might be in danger of being perceived as overreacting.

The Audit Committee members feel the need to oversee the proper functioning of IA, and require that they are involved in a number of areas. Such as planning, scope of services, hiring, firing and appraising the Chief Audit Executive, and highlights of audit reports. One special area of interest was breaches by top management of the code of conduct. This will be dealt with further below.

There are, however, some distinctions among individual Audit Committee members. Being an American, the new chairman of ABN AMRO's Audit Committee (as of January 1, 2004) has experience in the one-tier system and described the Audit Committee's notable rise in importance since Sarbanes-Oxley went into effect. Before that, it was more or less a breeding ground for less senior non-executive members. But due to its enhanced status this has changed significantly. He is now convinced that it should become more deeply involved with setting IA's agenda, and in that respect at least it is one of IA's masters. But he does not believe this creates the problem of "serving two masters" for the Chief Audit Executive. He contends that any professional should be able to deal with that.

Being experienced in the two-tier environment, the other members of the Audit Committee are of another persuasion. They acknowledge that the Management Board is the "master" and not the Audit Committee. Although the Charter allows the Audit Committee to require the execution of certain investigations by IA, which the two other interviewed members also acknowledged, they strongly agree that this does not imply "mastership". This is also supported by the Chief Audit Executive, who is, however, highly aware of the potential conflict of interests between the Audit Committee and the Management Board. He also stated that the Audit Committee's becoming more "probing" is probable cause to believe that this issue is becoming more important. The Audit Committee and the Management Board agree that due to changes in Corporate Governance regulations and discussions the Audit Committee is becoming more probing.

The CFO was somewhat reluctant to talk about conflicts. He preferred to describe the relationships between the Management Board, Audit Committee and IA as "interplay". Although the Supervisory Board sometimes meets with the Chief Audit Executive without the presence of the Management Board, the Audit Committee does not as a rule have separate meetings with him. He strongly supports the premise that the Chief Audit Executive should be able to speak freely and independently, and his professionalism should provide sufficient basis to do so. Since IA is traditionally an instrument in the hands of the Management Board, he opposes the idea that responsibility for it should be transferred to the Audit Committee. The former Chairman of the Audit Committee did occasionally confer with the Chief Audit Executive, either via phone or in person. Both reported these meetings to the Management Board in advance, and issues addressed were reported after.

The Audit Committee’s rise in importance is notable. As described by the CFO and the secretary of the Management Board, meetings with the Supervisory Board in the past, took longer than meetings with the Audit Committee. Nowadays, this has been reversed. The main issues around financial reporting, risk and control, are first addressed in the Audit Committee and then prepared for decision-making by the Supervisory Board.

As will be shown in Chapter 6, the general issue of the "mastership" of IA is reflected by the responses to the survey. There was some reluctance to score such questions as, "The IAF will be supervised by the Audit Committee due to the corporate governance regulation". This reluctance was especially true for members of the Audit Committee. The preference was for verbal discussions in detail.

In all the case study companies Audit Committee members are highly aware of the need to maximize IA independence. They supported the idea that that independence is increased when it does the supervising. Internal and external auditors also believe that direct reporting to the Audit Committee would maximize independence. What is remarkable, however, is the seemingly hard and fast position in all the companies that if the Audit Committee actually made a bid to take charge of IA, the Management Board would create a new, separate IA, which would report only to them!

BNG's Audit Committee has both the Chief Audit Executive and external auditor present in its meetings. IA submits its planning for review by the Audit Committee. Formally, the approval of the planning itself is reserved for the Executive Board. But they may ask the Executive Board to adjust it based upon their recommendations. IA reports high-level findings to the Audit Committee as well. The Audit Committee is involved in hiring the Chief Audit Executive and his resignation. Although these decisions belong to the Executive Board, commitment at the level of the Audit Committee is implicitly required and consultation preferred. One of the Audit Committee members expressed the view on hiring as follows: "The Audit Committee should have the right of refusal."

IA's position has always been at the highest level of the company. Until May 2003, it reported to the President of the Executive Board. That responsibility was transferred to another member of the Executive Board more familiar with the auditing profession, but that was only due to changes that took place within the Executive Board itself. But the Chief Audit Executive has unlimited access to the Chairman of the Supervisory Board and the President of the Executive Board. The Chief Audit Executive also has periodic meetings with the full Executive Board.

Two out of four Chief Audit Executive of the case study companies report to the CFO. One reports to another member of the Management Board. But all three are allowed to call upon the CEO and the Chairman of the Audit Committee when necessary. Only the Chief Audit Executive of IB Groep reports to the CEO.

Most of the external auditors of the case study companies have a clear vision about IA's independence. According to them, IA is part of the organization and by nature not independent.

Size and staffing of IA: rather stable numbers over the years

While theory does not directly provide clues regarding IA's size, it does so indirectly. These circle around the by now familiar themes of the level of Asset Specificity (Transaction Cost Economics), frequency of audits (Transaction Cost Economics), and Information Asymmetry (Agency Theory). These might lead to a greater need for audits - not only more of them, but also a greater variety in the scope of services - and thus a need for a larger IA. While the case studies corroborate this to some extent, there are some significant differences. ABN AMRO, for instance, has an IA of 750. TPG has only 49. In other words, in terms of staff the IA in one is more than 15 times larger than the other.

The explanation cannot be found in either the size of the companies - again, in terms of staff - or the spread of operations. ABN AMRO has 112,000 employees, TPG 160,000. The former's reach of operations is 67 countries, the latter's 62. Thus it must probably be sought in the industries they are operating in - financial versus mail/logistics - and, perhaps, their product portfolios. In that respect it might be true that once again Asset Specificity has more predictive power than Information Asymmetry since the complexities of the industry are more related to Asset Specificity than to Information Asymmetry. The scores for both Asset Specificity (ABN AMRO 82 versus TPG 73) and Information Asymmetry (ABN AMRO 43 versus TPG 53) do not differ much, which does not provide any ground for a conclusive conclusion as to the why of the huge difference in audit staff.

From the perspective of the size of the company, one might regard BNG's IA (7 out of a total staff of 400) and IB Groep (11 out of 1500), oversized. However, since there is a minimum limit to the size of their IAF's, especially when one takes into account the need to have several disciplines available, it seems to me that there is no possibility for them to gain in economies of scale.

In many cases IA staff numbers have done everything except decrease (see table below). TPG audit staff dropped from 50 to 49, but in 2005 rose to 55. BNG remained steady at 7. IB Groep inched from 8 to 11. At ABN AMRO, IA staff numbers over the years went up and down. But that was mainly due to repositioning of internal control staff to Group Audit. The actual number was by then 750.

Table 5-7 Staffing of IA in case study organizations

Staff level	ABN AMRO	BNG	TPG	IB GROEP
Total number	750	7	49	11
Years of experience	7	22	5	5
Budget (€ million)	105	0.7	6	not specified
Average age staff	33	48	35	not specified
Turnover rate per year	15	0	15	5

Based on the case studies, the educational level (see table below) went up during the last decade. Between 70-85% of the staff of ABN AMRO, TPG, and BNG are now chartered in Accountancy, EDP auditing, Operational Auditing, or other academic studies. Only IB Groep has a significantly higher percentage of higher vocational education trained staff: 63%.

Table 5-8 Educational level of IA staff in % in case study organizations

Education level in %	ABN AMRO	BNG	TPG	IB GROEP
CPA/RA	20	57	43	9
RE	15	43	12	18
RC	10	0	0	0
RO	10	0	7	9
CIA	15	0	9	9
Other academic	20	15	0	0
Higher vocational	10	0	17	63
Support staff	15	15	12	9
Other	0	0	0	0
Total	115	130	100	117

Totals may exceed 100% due to some overlaps

Some remarks were made regarding the level of IA's multidisciplinary knowledge of the business. Some point out that in that respect the quality of IA should increase. One interviewee pointed out that this could very well be realized by creating a two-way street breeding ground policy. However, the same interviewee questioned whether that would be feasible, because many managers might not see IA as a promotion. Although, interviewees had doubts about the quality of IA staffing, they did not have a simple solution to the problem and all companies seem to have accepted that. Based on the interviews, it seems that the level of the paycheck may be one explanation, which is, incidentally, consistent with Agency Theory. Chief Audit Executive's were not always paid the same amount as their peers in the company.

How to control IA

In almost all companies this is a less well-discussed and developed area. It is not easy to find measures that capture IA's performance level in achieving its objectives. A major obstacle to pushing ahead in this area is the difficulty in quantifying what those objectives are.

In this respect Internal Audit is not much different than other services: more difficult to measure and monitor than physical goods. In other words, despite the old jokes, it's no longer about counting the number of beans in the jar. This was already discussed in Chapter 2. First, it is difficult to find suitable performance metrics. Second, it is yet another issue of how to reward the Chief Audit Executive. If it is difficult to find the right metrics to assess the performance of the Chief Audit Executive, then it will be equally difficult to assess the right level of incentives and rewards.

For the latter, Agency Theory offers some ideas. There are three main areas to explore. First, it is possible to link performance metrics for the Chief Audit Executive to the overall financial results of the organization. Many consider this undesirable, because it could hamper the Chief Audit Executive's objectivity. In order to protect and even bump up his own interests he might be tempted to go with the flow instead of reporting unbiased what is going on in the organization. Second, it is also possible to create incentives that are linked to non-financial results of the company. Although many think those are preferable, there is no inherent reason to consider them better. Because they too might hamper his objectivity. The third option is the setting specific, predefined specific goals for the IAF/Chief Audit Executive. But as we have already seen that is extremely difficult. So let's see how these issues are tackled in our case study companies.

A seeming exception to the rule was the well-defined and objective goals found at TPG. A total of 25 performance indicators were established. Examples are: percentage of audits completed (versus plan); percentage of Control Risk Self Assessments (versus plan); employee satisfaction survey results; timeliness of staff performance appraisals; training days per employee, and internal customer survey results. One might argue that there are a few that are hard to measure. Such as: staff quality indicator. This is calculated using such metrics as diplomas and turnover, which, if actually used, probably leads to complex numbers that conceal more than they reveal. Management succession plan in place is another. The existence of such a plan all by itself is not scored positively. It is the quality of the plan that counts. But how do you measure that? Against what framework and background? What is the norm?

Within TPG, however, those objectives are connected to a performance based pay of the Chief Audit Executive. There is a relation between his annual pay and whether or not he met his goals. Thus real incentive is built into his contract, which is what Agency Theory recommends.

Within ABN AMRO, each year clear objectives are drafted in advance to guide IA operations. IA provides on a regular basis the Management Board and the Audit Committee with reports that state the status and progress of its audits. The process seems to be both objective as well as subjective by nature. Unlike the other Chief Audit Executive's interviewed, this one is rewarded according to a performance-based contract. These performance criteria do not include the financial outcome of the Bank as a whole, but specific goals for the IAF/Chief Audit Executive. ABN AMRO's practices seem to be in alignment with Agency Theory, because it views performance-based rewards as a tool – incentive – to steer behaviour.

By contrast, the questionnaire among the other case studies showed significant conformity in the opposite direction. That is, among the Management Board, Audit Committee or Chief Audit Executive, no one really favors performance-based rewards for the Chief Audit Executive. Interviewees said this might lead to behaviour that does not contribute to IA objectivity.

One possible other explanation might be that both ABN AMRO and TPG are large organizations that use performance based incentive schemes all the time and across the board and are, therefore, quite at home with them. This is not the case for both IB Groep and BNG. It should be mentioned that BNG has performance based incentive schemes but on a much smaller scale than ABN AMRO and TPG.

Another equally, if not more, substantial problem is that any appraiser would need highly specific knowledge to be able to adequately assess the indicators. They say that it takes a thief to catch a thief. And the same could be said - with the necessary changes, of course - in the field of auditing. One of the solutions for overcoming these problems is to make use of the external auditor. With the exception of TPG, the external auditor performs ad random checks on the quality of IA.

In many respects, using external auditor to "audit" Internal Audit is a highly commendable approach. But there are downsides as well, especially when the Chief Audit Executive is supposed to monitor external auditor's performance. This hand in glove circularity might lead to situations of unwished for intimacies. Unwished for on the part of both the Audit Committee and Management Board, not the auditors themselves. They might quite easily fall into the trap of "I'll scratch your back if you scratch mine" and cut each other all too much slack. As already noted by Antle (1982), the Chief Audit Executive is just as human and an self interested economic agent as everyone else.

Monitoring IA is quite often done by regulators, other supervisory bodies, or professional bodies. ABN AMRO and BNG are also monitored by *De Nederlandsche Bank* (DNB). In the case of ABN AMRO there are quite a few other regulators and supervisors, mainly abroad, assessing the quality of its IA. Supervision of IA by such professional bodies as the *Nederlands Instituut van Register Accountants* (NIVRA, Dutch Institute of Registered Accountants) and IIA The Netherlands is still so minimal that a good case could be made for its non-existence. The IIA The Netherlands issued a Quality Assurance standard to be adopted by members. This standard was accepted by them in a June 2004 meeting. It recommends monitoring members and their adherence to the Standards of the IIA Inc. This is done every four years by assessing IAF's.

In terms of the numbers, it is much easier to assess whole departments than individuals. There are simply less of them. But that doesn't make the problem go away, because the assessing will be done by the members themselves. One can almost hear the backs being scratched from here. In other words, independence and objectivity might be issues. The IIA The Netherlands announced that it would review the policy in a number of years to see whether these problem have in fact come up. How they plan to discover and assess whether when and how often that occurs remains a mystery.

The policy is not aligned with the one of the IIA Inc., which states that an *external* (my emphasis) party should review every IAF every five years. External in this respect is certainly not a member of the IIA Inc. Up till now, no "external party" has formally reviewed any IAF of the case study companies.

Such measures as client and employee satisfaction surveys are used inside all the case study IA's. In addition, all have a quality assurance process, which uses an audit manual and, in many cases, software tools to demonstrate the proficiency of its operations.

During the interviews I asked whether measures applied to the external auditor - peer reviews, external oversight, quality and risk management systems, and rotation on partner level every 7 years - should also be used with internal auditors. A number of respondents, especially at the Supervisory Board/Audit Committee level, said that there might be some value in that. Others said that this would create too much of a burden on IA without significant gain. As far as rotation is concerned, some see a definite dynamic - and a need to find the exact balance -

between experience with one particular company and myopia. Some state that in-depth experience is an essential element of any good Chief Audit Executive and at the heart of his value added. Others contend that staying in the same position for too long - 5 to 10 years[77] - can lead to staleness and missing the bigger pictures.

All the respondents agreed with the statement that IA will be subject to more reviews, and will increasingly have to account for its actions. All interviewees recognized that the increased regulation emphasizes the need for quality assurance and the effect it will have on the operations of IA. This will ultimately create a need to document all actions and will inhibit informal communication, so treasured by many internal auditors. In other words, while contributing to more transparence in the companies they work for, they will have to become more transparent themselves. It is envisioned by most of he interviewees that such measures could drive up IA's quality. But one Management Board member was concerned that it might be too much to chew on and there could be overkill.

Another side effect of enhanced focus on Corporate Governance regulations is that it will foster a more compliance-oriented approach by IA. What, when and how IA brings issues to the attention of those concerned will be more in writing and more formally documented. If something goes wrong, terribly or otherwise, IA will need to demonstrate where it was at the time and what it was doing.

In the current environment, IA might on occasion be able to act informally, enabling a smooth, good old days process while achieving the same, or better results than formal and in writing. But that approach is fast on its way to becoming ancient history. Most regretted the increased orientation of a compliance-oriented approach. Some said it might be counter-productive. All said it was inevitable.

5.4.3 Scope of services

There is a trend regarding the scope of services. It is not described, nor even mentioned in the literature. But it becomes rather clear to those who have been around in the profession for a while and have surveyed the data. That is, to make yourself as indispensable as possible by offering whatever services are being clamored for at any given moment. I already discussed in Chapter 2 the "unbundling" framework provided by Matthyssens et al. to provide some explanation for this contention. Their framework gives rise to at least two questions.

One, why is there a need to become a jack of all trades and to promise probably a lot more than you can deliver? Unlike most other things in this tangled tale, that's quite simple. Because up till now there is nothing self-evident and obvious about Internal Audit. And on the whole - that is, in most sectors and most countries - it has not been mandatory. Thus in order to justify its continued existence it has to keep on proving itself.

Two, what is the market? Or to be more precise, who is the market? The answer to that is equally simple. Up until now, it has been first and foremost some level of management, either at the lower levels of the various lines, or in the executive suite on the top floor. Staying alive meant doing management's bidding, and doing it well.

[77] There have been some studies that revealed that the average number of years of Chief Executive Officers being in office is declining. Although there hasn't similar studies for Chief Audit Executives there is at least some anecdotal information that this might be true for them as well.

Starting off with its focus on financial audit, closely working together with the external auditor and providing assurance on the financial data, IA sought to expand its empire of services to other areas. The financial audit became a commodity, which was also provided by the external auditor. This competitive force led the profession down the path of differentiation and finding new services. For example, operational audit, IT audit, compliance audit, and the like. With consulting services the bag of tricks swelled out even more.

Some might ask whether this was market pull - management demanding more services and IA rising to the occasion - or push - the profession inventing "diseases" and then serving up the "cure". That might be another of those unanswerable chicken or egg question. However that may be, the results are the same. For an overview of the current data take a look at the table below.

Table 5-9 Time spend by IA in %

Time spend by IA in %	ABN AMRO	BNG	TPG	IB Groep
Financial Audit	7.5	2	44	5
Operational Audit	55	30	14	65
Compliance Audit	not specified	15	8	2.5
IT/EDP Audit	30	30	14	20
Fraud/investigations	10	0	4	2.5
Consulting	0	10	5	not specified
Other	0	13	26	5
Total	102.5	100	115	100

Totals may exceed 100% due to some overlaps

The version of the questionnaire used in the case study companies (see Appendix 5) also surveyed the need for certain specific audits. It turned out that among those surveyed there is a widespread belief that IA's scope should be even further broadened and include such areas as the tone at the top/ethics, reliability of non-financial data, risk management, effectiveness and efficiency of operations, and change processes. The data also shows that it is not just a broadening. More audits with higher budgets are also foreseen. This in itself might cause further diversification instead of a turning back the clock towards plain vanilla financial audit as some predict as a consequence of Sarbanes-Oxley. Time will tell who is right.

While Supervisory Board/Audit Committee members don't formally and specifically call upon IA to report about the "tone at the top", they do expect them to do so when there's probable cause. Probable cause in this case being somewhere in the neighborhood of possible breaches of codes of conduct by senior officers, which, following the charter, should be reported to the CEO. If the CEO himself is involved, it should go to the chairman of the Supervisory Board. This might remind some attentive readers of the high risks involved with the "escalation procedure" discussed above. Clearly, this is a hyper-sensitive area where just rolling out of bed in the morning could place the Chief Audit Executive squarely between a rock and a hard place. In other words, it's a trap easier to fall into than avoid or climb out of.

The issue of performance measurements and incentive systems is not only highly sensitive, but also murky. Agency Theory emphasizes that behaviour is geared towards objectives via performance measurements and incentives. Thus from a theoretical perspective, excluding this area from internal audit seems ill advised. The offense is compounded when we consider that audit outcomes are actually used to appraise managers.

IA is expected to assess the application of performance measurement and incentive systems below the level of the Management Board. But when it comes to the Management Board or the level just below, this seems to become more ambiguous, to put it mildly. Neither the Management Board nor the Supervisory Board call upon IA to make this part of their scope of services. Since management control is all about influencing the behaviour of people - as we have seen in Chapter 4 - and Agency Theory alerted us to the fact that incentives are one of the best instruments to do just that, this is strange. Many of the scandals we have witnessed lately are, at least allegedly, caused by the dysfunctional use of incentive schemes. Thus if this is not included in IA's scope of services, it will hamper the effectiveness of the assessment of the Management Control System. Call it a three wheeled car.

The advisory/consulting area presents a surprising score. All parties, except IA itself, seem to be rather indifferent about advisory services. The consulting part of the scope is prominently written down in many IA Charters, and the case studies as well. What is surprising though is that management and supervisors hold a more reticent position and do not overwhelmingly support the need for more advising. Members of the Audit Committee explicitly stated that assurance is their primary concern, and they expect that service primarily being rendered by IA. The external auditor emphasizes that they look upon IA as an assurance provider, regardless of the stress on the consulting/advisory services in other utterances. Management Boards are more demanding for advisory services. But they too tend to focus mainly on assurance services. As is demonstrated by the definition of Internal Audit by IIA Inc., the IA profession itself has made a special case for advisory/consulting services. Internal auditors in general and the ones in the case studies in particular firmly believe that providing "added value" is what is needed and that advisory services is a unique opportunity to do just that.

Looking at the confusing, and perhaps even contradictory, array of opinions, we could think that we have landed in another important morass. However, when one confronts the actual time spent on consulting services (0-5%), then the issue looks more like a tempest in a teapot. Like the make or buy hot topic.

Some specific observations for the case studies

ABN AMRO shifted their main focus towards operational auditing in 1993, IB Groep in 1994, and BNG in 2000. They all handed over the financial audit work to the external auditor. TPG, as was often the case, was the exception to the rule. They more or less stuck to financial audit during the last decade. If one slotted IT/EDP auditing under "operational auditing" – which from a professional perspective can be easily defended – the numbers are as follows. ABN AMRO and IB Groep spend 85% of their time on operational audits and BNG 60%. For TPG the number is a mere 22%.

Having studied developments in a broader sense, one is tempted to say this is true for the internal audit community in The Netherlands. The numbers were as follows:

Table 5-10 Average time spend in % by IA's in The Netherlands

Average time spend by IA in %	Financial audit	Operational audit	Compliance audit	Other
1991	46%	32%	**	22%*
1998***	30%	51%	9%	10%
2000****	22%	45%	9%	24%****

* IT accounted for 12%
** not specified
*** no IT included
**** IT accounted for 16%

The percentage of time spent on operational auditing (including IT auditing) in 2000 was 61. Taking into account the upward trend, this number might now be even higher. Chief Audit Executive's in all case studies acknowledge that due to such initiatives as Sarbanes-Oxley a turning back the clock towards financial audit is looming.

This seems to be the case for ABN AMRO. In March 2003 a new strategy for Group Audit ABN AMRO was drafted.[78] What is striking in the strategy document is that it states: "a more balanced audit focus between operational and financial audits is preferred". The document stresses the need to "pursue a situation of well-aligned coexistence of internal and external audit and that this should lead to frequent, transparent cooperation, based on mutual recognition of professionalism". The document also elaborates on "the need to play a balancing act of being auditor and business consultant without crossing the borderline of conflict of interest". The data shows that it is expected that the amount of financial audit, now about 5-10%, will increase.

Once again, TPG is an exception to the rule. The focus was shifted towards a combination of not only financial audits, but also operational, compliance, and risk-based audits. Today the aim is to provide so-called "integrated audits". Its vision states: "Corporate Audit Services will function as independent professional partners of TPG management. We will add value by developing and providing global 'best in class' internal audit services, covering the full spectrum of financial and operational risk faced by the group."

The Audit Committee asked to put some emphasis on fraud investigations, and this is now mentioned in the scope of services in the CAS Charter. CAS is involved not only in the risk management process, but also the Sarbanes-Oxley 302 and 404-compliance process. The Chief Audit Executive expects that this will foster compliance auditing. There is a huge emphasis on adhering to policies and procedures within TPG. CAS audits adherence.

[78] Group Audit 2003-2008 Strategy Document, March 2003

Compliance officers and the legal department take care of aligning policies with applicable laws.

Interestingly enough, the survey showed that almost all tasks performed will either remain at the same level or increase. In some cases, the breadth of services is also expected to rise. For example, the IB Groep. The Chief Audit Executive expects an increase in financial audit and, consequently, he will probably become more involved with the External Auditor. In addition, he foresees a rise in IT/EDP, compliance, and quality audits. He also anticipates a larger involvement in change processes. According to his expectations, only the current tasks in the area of operational audit will decrease.

At BNG the Audit Committee also mentioned that they will expect IA to address issues with respect to culture and the adherence to the values and principles of BNG. The so-called tone at the top is highly valued by the Audit Committee members and should, therefore, be taken into account by IA in the course of fulfilling its duties. Although in agreement with the importance of this aspect of the business, Executive Board members doubted whether they themselves would specifically request any formal audits focused on tone at the top issues. They questioned the possibility of coming up with a framework that could be used as a normative set that could be properly tested. Of course each and everyone was clear that if management fraud was obvious, this should always be addressed by IA at the highest level: *in casu extremae necessitatis*, the Audit Committee.

With regard to the reliability of financial information one Executive Board member noted that there is an increasing amount of financial data that is not included in the traditional financial statements but, nevertheless, is vital for controlling the organization. This is similar to conversations in the aviation industry. Namely, that what is recorded in the black box doesn't tell you everything you need to know about crashes. Since this information is not included in the external auditor's scope of services, he wanted it to be included in IA's. Already in 2004 BNG's IA said it would focus more on the reliability of financial data and management information and reporting than they had done in the recent past.

These results are remarkable. Because if bigger, better and more audits are being called for there are only two ways to accomplish that. One, increase staff and budget. Two, improve in efficiency. No one has chosen the first option. In fact, quite often the reverse is the case. Thus, obviously the gap will have to be filled by increased efficiency.

The relationship with the external auditor: increased need for coordination

Officially, the relationship between the external and internal auditor is fine. And if it ain't broke, don't fix it. But just below the for publication image, a quite different story is playing out. As is all too often the case. External auditors tend to look down their noses at internal auditors the way most men - "in the good old days, when men were men" - used to look at women: as failed or at least flawed versions of themselves. From the other side of the divide, external auditors are seen as "city slickers". Despite their smooth talk and high fees, they don't really understand the business. Sometimes these underlying prejudices surfaced during the interviews.

Typically, the relationship between IA and the external auditor is that at least planning and reports are shared. In a limited number of cases internal audit time is spent supporting external auditors in their task to provide assurance on the reliability of financial data. Another example is the joint drafting of the management letter. As noted above, the external auditor is – except for TPG - monitored by the internal, and vice versa. In some cases the budget for the external auditor is in the hands of the internal auditor.

If that wasn't bad enough, there is every indication that it could soon become worse. Why? Because, as all respondents agree, in the near future the level of interaction between external and internal auditors is expected to increase. The main driver for this will be Corporate Governance regulations, such as Sarbanes-Oxley and Tabaksblat, and the predicted turning back the clock toward financial audit. There will be more contact between them, and that contact will become more intense, as they discuss, plan and, yes, compete in their quest to provide the best product at the best price. That is, in part, by avoiding gaps and overlaps.

For ABN AMRO, TPG and IB Groep cost containment of the external auditor is one of IA's goals. For ABN AMRO and TPG, which do business in the US and, therefore, have to adhere to Sarbanes-Oxley, IA is further tasked with monitoring adherence to the Auditor Independence Policy.

The Charter of ABN AMRO includes the liaison with the External Auditor. It says: "In this respect, the external auditor must be able to rely to a very large degree on the opinions of Group Audit." As stated by the former Chief Audit Executive, the main objective of the bank's external auditor, Ernst &Young (E&Y), is to supervise and oversee the work being done by Group Audit. The Charter notes that the goal is to realize an integrated audit approach by coordinating and harmonizing the work performed by Group Audit and the External Auditors. "This should result in few, if any, overlaps and duplications, while at the same time there is certainty that no areas remain uncovered and that the audit as a whole is cost effective."

It was noted in several interviews that the external auditor should be kept at "arms' length". And "Group Audit's work should significantly reduce the amount of work to be performed by the External Auditor". The external auditor should oversee the work performed by Group Audit and make sure IA is adhering to professional standards. In this respect, the Charter refers to the Code of Conduct and the Standards of NIVRA, the International Federation of Auditors, and relevant local Audit Associations elsewhere in the world. The Charter also mentions that they should meet the requirements/standards of Supervisory Bodies worldwide. It is noteworthy that the IIA Inc. is not among those mentioned.

The relationship between Group Audit and the external auditor has not much changed since 1993. There is a clear distinction between their scope of services. Insofar as EA is expected to build on work done by IA, it also monitors its quality. A management letter is drafted per Strategic Business Unit (Supervisory BoardU), discussed in the "local Audit Committee", and then condensed into a "top-letter" presented to the Audit Committee of ABN AMRO Holding NV. The top-Letter is predominantly a product of Group Audit, not of their external auditor.

The Chief Audit Executive of IB Groep maintains relationships with other supervisors, such as the external auditor, the auditing departments from the Ministries of Finance and Education, Culture and Science, and the General Auditor's office. It is his intention to establish a larger degree of alignment and coordination between the activities of these officials, even though their roles will remain autonomous. That in itself creates difficulties. The external auditor applauds the Audit Committee's increased independence and sees that as an opportunity to enhance the independence of the internal auditor. He also believes that the appointment of the new Chief Audit Executive (with his professional background) will mean frequent discussions between, which will improve the services provided by both.

At BNG, IA's relationship with the external auditor has changed since 2000. The shift away from financial audit and towards operational audit has created a whole new situation. Before that the external auditor audited the financial accounts and relied to some extent on IA's work. But by the end of 2003 the level of cooperation was limited, and the acting Chief Audit Executive did not foresee that the relationship would alter significantly. But with the arrival of the new Chief Audit Executive at the beginning 2004, this changed significantly. The idea now is that the two should cooperate far more intensively.

At TPG, IA's relationship with the external auditor has not changed much since 1993. There is a clear distinction between their respective scope of services. Since the external auditor builds only partially on the work done by CAS, it does not monitor the quality of the latter's work. CAS, on the other hand, does review on an ad hoc basis the quality of the external auditor's work and its adherence to the Auditor Independence Policy. Reports are shared. But CAS does not present the final scores they express at the end of an audit to the external auditor. Up until 2003, CAS was responsible for the budget for the external auditor. This created room for potential friction and conflicts of interest. Because if the external auditor ever became responsible for monitoring the quality of CAS' work, this might backfire on them through the budget. This has now been changed. The budget is in the hands of the Corporate Controller, which is a more preferable situation. It helps prevent any potential "I'll scratch your back if you scratch mine" situation between the Chief Audit Executive and the external auditor.

5.5 Discussion and Conclusions

We started off this chapter by reviewing both the condition we left IA in at the end of Chapter 2 and how Agency Theory and Transaction Cost Economics (discussed in Chapter 4) might help alleviate some of the issues. Since there was a need for some enhanced theory we set our course straight for case studies. It is now time to take stock of the progress made.

Let's start by looking at the findings of the case studies, briefly discussing them and trying to reach some conclusions. Below is an overview of the findings of the case studies plotted against the tentative conclusions drawn at the end of Chapter 4. They are grouped around the three elements: Role, Position, and Scope of Services.

Discussion on Role

Table 5-11 IA's Role: Case Study Results Compared With Tentative Conclusions From Theory[79]

	Conclusions derived from Agency Theory and Transaction Cost Economics				
No.	**Role**	**IBG**	**BNG**	**TPG**	**AA**
1	Internal Audit is an instrument to reduce agency problems arising from Information Asymmetry.	+	+	+	+
2a	Asset specificity explains the rationale of IA.	+	+	++	++
2b	Asset specificity is an explanatory factor for IA's size.	+	+	0	++
3	Internal Audit is cheaper and External Audit is better.	-	-	-	-
4	If risks are high, outsourcing IA is preferable.	--	--	--	--
5	Increased levels of Information Asymmetry create the need for IA.	+	0	+	+
6	Asset Specificity (knowledge of the organization) is a contributing factor for IA's size.	+	++	0/+	++
7	In cases of outsourcing a qualified staff member is required to supervise the IAF.	NA	NA	NA	NA
8	In cases of outsourcing it is preferable to split audits into phases and among competing parties.	NA	NA	NA	NA
9	If highly specific knowledge is needed to conduct audits, IA will be in-house.	++	++	++	++
10	The larger the size of the organization the sooner economies of scale foster in-sourcing IA.	+	0	++	++

Let's now take a closer look at the results of the case studies. We will discuss them in the order of the table above.

[79] The scale that is used varies from ++ (very much so, strongly supported) to -- (not supported at all). 0 means that they are more or less indifferent. NA is not applicable, meaning that in this particular case this was not an issue.

(1) Internal Audit is an instrument to reduce agency problems arising from Information Asymmetry.
(5) Increased levels of Information Asymmetry create the need for IA.

In the companies studied the degree of Information Asymmetry didn't vary much. Large or small, it seemed uniformly low. That finding might be attributable to the fact that the people I interviewed were high level and very seasoned officials in the companies and both knew where to look for information and how to assess its quality. It might equally be due to them not being aware of the complexities of Information Asymmetry and the issues revolving around the reliability (or lack thereof) of written and oral reports. There is no way of deciding where we should throw our weight. Which all by itself might tell us something about the usefulness of Information Asymmetry as a say something theoretical metric. The *measured* information is equal to *perceived* Information Asymmetry. Further, not having any already tested and validated proxies available, it might be that the ones I selected were not the most suitable.

Some evidence for that might be found in area of the scope of services. During the last decade that has changed dramatically: from mainly financial auditing to other auditing forms and mutations (with a focus on operational auditing). The assurance about the reliability of fiscal reports was relegated to the task pile of the external auditor. While I used questions about the reliability of financial information to assess the level of Information Asymmetry, this might barking up the wrong tree. Since these days that is more the bailiwick of the external auditor, not the internal. Further research under semi- stable conditions might come up with better indicators for Information Asymmetry.

Nevertheless, and despite the above caveats, Information Asymmetry definitely exists, and it is our strong belief that that is a factor for having internal auditing. What makes this more than "expert opinion" is the fact that it is shared by those interviewed. There is a clear perceived belief that IA helps provide the assurance all board members need to check the pulse of the organization and test its health. This belief is corroborated by the putting your money where your mouth is long range history of IA in the companies and the fact that its size held steady during a decade of nearly continuous cost cutting and downsizing. Another, perhaps quirky, example was the surprising revelation in one company that if the Audit Committee were to take charge of IA, the Management Board would calve off and create another one for itself.

All in all, Information Asymmetry is present and contributes to the perceived need to have IA. This contention is based more on the qualitative and corroborating findings of the case studies and the answers provided by the interviewees than quantitative data. And it is exceedingly improbable that we can tweak the limited and inconclusive Information Asymmetry numbers we got from these case studies to come up with even soft and loose relationships between it and IA size. I will be studying that issue in more depth in the next chapter.

(2a) Asset specificity explains the rationale of IA.
(2b) Asset specificity is an explanatory factor for IA's size.
(6) Asset specificity (knowledge the organization) is a contributing factor for IA's size.
(9) If highly specific knowledge is needed to conduct audits, IA will be in-house.
(10) The larger the size of the organization the sooner economies of scale foster in-sourcing IA.

Asset specificity does seem to be an explaining factor for the existence and the size of internal audit, and when it increases it very probably leads sooner to a "make" decision. It - especially the specialized knowledge needed for performing good audits - is the factor most underscored as the reason for having IA. However, "make or buy" has not been an issue in any of the case studies. It is simply not an option. One might wonder whether this is due to high Asset Specificity or the lack of thorough decision making process that places all the possibilities on the table and then picks one or two. It might be that those organizations have a prejudice in favour of IA. Therefore, based on these studies alone, there is no evidence for the Asset Specificity argument. But the bigger the organization, the sooner economies of scale foster in-sourcing IA is supported by the case studies.

It is more difficult to use Agency Theory or Transaction Cost Economics to detect a relationship between the size of the company and the size of IA. Although size contributes to tendency to in-source, there is no way to tell how large it should be. While the absolute numbers in our case studies differ dramatically (ranging from 7 to 750), the relative numbers tell a less enlightening tale. ABN AMRO has one auditor for every 150 employees. BNG, the other financial services company, which is considerably smaller, has one for every 60. For the non financial services organizations the numbers are even more say nothing. The giant TPG has one auditor per 3,000 employees. The midget IB Groep one per 140.

Comparing those numbers with the scores on Asset Specificity did not provide any further clues. But since there is probably a limit to just how small (or large, for that matter) an IAF can be, it seems that smaller companies will have a higher ratio of auditors per employees. Using the ABN AMRO ratio for BNG would lead to a mere 2.6 auditors. Using the TPG ratio for IB Groep would lead to 0.5 auditors in total. Those are not sustainable numbers. The economies of scale argument seem to be backed up by those numbers. Hopefully, the survey, providing more data, might be able to support any conclusions in this space. It might also be possible to see whether there is any threshold for IA size to make it sustainable.

(3) Internal Audit is cheaper and External Audit is better.

As shown in Chapter 4 this tentative conclusion was the outcome of the model used by Caplan and Kirschenheiter (2000). Although saving on audit costs play a role in having IA, the bigger factors are Asset Specificity and Information Asymmetry. None of the interviewees said that audit costs all by themselves led them to even consider the buy position. The same is true for the argument that the external auditor does a better job. In fact, there was a widespread belief that the opposite was the case. The external auditor would do distinctly worse than his internal colleague because of his lack of understanding of the internal dynamics of the organization: its culture, people, ways of doing things, and other vague variables. Even suggesting that external audit shops could provide specialized teams that would operate within the organization was not at all welcomed. They would still be seen as outsiders and, therefore, not as "one of us".

(4) If risks are high, outsourcing IA is preferable.

Theory and models used by Caplan and Kirschenheiter (2000) support the idea that outsourcing is sooner an option in situations where there are high risks. One looks for the best auditor - allegedly, the external auditor - with the deepest pockets, because of the threat of irate stakeholders claiming damages when shortcomings in management control system are not detected on time. However, this is contradicted by the case studies. This argument never came up during interviews. Even when it was pointed out as a possibility to consider, everyone waved it away. Liability claims are never taken into account in connection with the make or buy decision. But then again, the make or buy decision itself is also not taken into account.

(7) In cases of outsourcing a qualified staff member is required to supervise the IAF. (8) In cases of outsourcing it is preferable to split audits into phases and among competing parties.

Since outsourcing was not a viable option in any of the case study organizations, these issues did not apply. Thus no evidence could be found to tilt the argument one way or the other.

Discussion on Position

Table 5-12 IA's Position: Case Study Results Compared With Tentative Conclusions From Theory[80]

	Conclusions derived from Agency Theory and Transaction Cost Economics				
	Position	**IBG**	**BNG**	**TPG**	**AA**
11	Reporting to the Supervisory Board/Audit Committee is the preferred option	-	-	-	-
12	*IA's size is dependent on the:*				
12a	Size of the organization	0	-	+	++
12b	Use of subjective and objective incentives schemes and performance based contracts	0	0	0	+
12c	Trade offs between internal and external auditors	0	0	0	0
12d	Level of risk management is willing to take	0	0	0	+
13	*IA's agency problem is addressed by:*				
13a	A code of conduct	++	++	++	++
13b	Internal quality measures	++	++	++	++
13c	Performance based appraisal of the Chief Audit Executive	--	--	++	++
13d	Ad random checks of IA by the external auditor	+	+	+	+
13e	Hiring qualified auditors	++	++	++	++
13f	Applying credible disciplinary powers	0	0	0	0
13g	Adhering to Professional Standards	++	++	++	++

We will discuss them in the order of the table above.

[80] The scale that is used varies from ++ (very much so, strongly supported) to -- (not supported at all). 0 means that they are more or less indifferent.

(11) Reporting to the Supervisory Board/Audit Committee is the preferred option

Based on Agency Theory, IA's organizational position needs to be as independent as possible. Thus it predicts that it should be positioned close to the principal. And this is definitely the case with the external auditor. However, in our case studies (and elsewhere) IA is positioned under the jurisdiction of the Management Board and is, therefore, a "bonding" instrument. From the perspective of the principals, or their representatives (e.g., the Supervisory Board/Audit Committee), does such a bonding instrument have any value? Yes. This is based on two factors: one positive, one negative. One, IA's reports to Supervisory Board/Audit Committee members helps provide them with the necessary assurance. And two, their reluctance to assume full, or even major responsibility for IA.

Nevertheless, Corporate Governance regulations are urging Supervisory Board/Audit Committee's to exercise oversight over IA in order to enhance its independence. And the Supervisory Board/Audit Committee members interviewed acknowledged that having IA report to them would achieve just that. The reluctance, however, might be based on a completely different issue. Namely, the belief - not only among them, but also Management Board members - that too close a relationship with IA might not be in the best interests of the latter and, ultimately, the company. Especially if that relationship eventually replaced the more traditional close and direct relationship with the Management Board.

The case studies demonstrated that over the years there was an increase not only in direct contacts between Supervisory Board/Audit Committee and IA, but also in meetings without the presence of Management Board members. Whether or not this will eventually lead to the Supervisory Board/Audit Committee becoming fully responsible for IA remains to be seen. Based on current trends and the evidence gathered here, that is highly unlikely.

(12) IA's size is dependent on the: (a) size of the company; (b) use of subjective and objective incentive schemes and performance based contracts; (c) trade offs between external and internal auditors; and (d) level of risk management is willing to take.

As shown in section 5.5.1, there is some evidence that there is some sort of relationship between the size of the organization and the size of IA. Economies of scale (as with ABN AMRO and TPG) allow for a larger IA. But that doesn't tell the whole story. Because we also have to consider ratios (number of IA staff per number of employees company wide). In terms of relative size, TPG has the smallest. BNG and IB Groep, by contrast, have relatively large IA's. This might be explained by the how low can you go principle. In other words, there might be a strict minimum number of IA staff. Below that it is no longer a working proposition.

Very little has been found in the case studies to demonstrate that the use of subjective and objective incentive schemes and performance based contracts, the trade offs between the external and internal auditors, and/or the level of risk management is willing to take have significantly impacted IA size. The exception to that trend was ABN AMRO, where subjective incentive schemes and the level of risk management is willing to take contributed somewhat to the need to have IA and, therefore, (very) indirectly to its size.

As was already shown in Chapter 4, theory provides no clues about how large any particular IAF should be. My case studies also don't bring anything to the table. Hopefully, the survey, which will be discussed in Chapter 6, will be more helpful.

(13) IA's agency problem

Theory provided a number of clues about what elements are needed to address IA's agency problem. The case studies showed that many of them are being applied. Codes of conduct exist in all four. Internal quality control measures were taken in all of them, and there were also specific requirements regarding the qualifications and level of proficiency of auditors. Professional standards were applied and adhered to, enforced by the quality management systems in place. For the most part this could not have been otherwise, because the Professional Standards require adherence to them as well as having a code of ethics and maintaining some kind of quality control system. Hiring qualified auditors seem so obvious that it hardly seems worth mentioning.

However, there were a few elements that were only partially supported by the case studies. The most visible being the performance based remuneration of the Chief Audit Executive, based on finding shortcomings in the control measures of the organization. Or demanding penalties when shortcomings have not been discovered in a timely fashion. Performance based appraisal and subsequent pay are applied in the two large organizations (ABN AMRO and TPG) but not in the smaller (BNG and IB Groep). Since larger listed companies like the first two have a long history of using such systems, it is not surprising that our case study companies in the same bracket follow suit. It also shouldn't raise too many eyebrows when discovering that IB Groep does not use these metrics, because it is a public entity and they have only limited application elsewhere in the organization.

It is worth noting that the Chief Audit Executive's of both BNG and IB Groep were reluctant to get paid according to those metrics, because they thought it might hamper their independence. Surely, connecting the performance metrics to the performance of (parts of) the organization that needs to be audited seems unwise. However, there are specific targets that do not hamper independence. For example, finding shortcomings in the control systems. The reason why this was not applied might be due to the "added value" image Internal Audit was striving to create over the last decade - being a management tool and consultants to the company. In short, anything but the traditional policeman - the much feared and resented "hatchet man". And while such metrics are completely appropriate for the latter, they are far below the dignity of the former.

While all companies used appraisal systems for the Chief Audit Executive none of them included the amount of shortcomings in the control systems revealed by the Chief Audit Executive/IA. It also turned out that performance metrics varied considerably. TPG had over 20. Thus while Agency Theory has much merit in the area of performance related incentives, they are not uniformly applied to Chief Audit Executive's.

Second, a somewhat reversed situation is noted regarding the use of the external auditor for ad random checks of IA. This is used for the smaller organizations (IB Groep and BNG) and TPG, but not for ABN AMRO. For ABN AMRO the rationale could be that Group Audit is subject to supervision by many supervisors and regulators and predominantly focuses on operational audits whereas the external auditor is meant to focus on the financial audit, thus, creating a situation of less interdependence. The external auditor also might not be best fitted to scrutinize Group Audit's work because of its completely different nature. TPG's CAS, by contrast, still focuses on financial audits - the external auditor's playing field - and being scrutinized by the latter seems perfectly natural.

The last one not being applied is the credible disciplinary powers for internal auditors. Although there are disciplinary powers within the organization, external ones predicted by theory and applied by the profession and are not "credible". The very fact that there are next to no cases of IA's having being subjected to disciplinary powers by the profession clearly demonstrates the lack of enforcement. Surely, one cannot hold the respective IA's or Chief Audit Executive's accountable for that.

Disciplinary powers, which should be promulgated by the profession, presuppose that at some point someone will file a complaint. In The Netherlands this can be done by any number of people and organizations. The Chief Audit Executive, other IA personnel, the external auditor the company, professional bodies, or the public at large. Except for the last item on the list, all of the above have, in theory at least, the requisite expertise to know what to look for and how to make the charges stick. With that in mind, let's examine who the most likely "whistleblowers" will be. Or, more precisely, who they won't be.

The Chief Audit Executive, because he is hardly likely to report himself and colleagues (who he is responsible for). Those colleagues. Not only because they might not be aware of everything the Chief Audit Executive is doing, but also because of the *esprit de corps* - we're all in this together - and the desire not to be seen by friends and colleagues as a "rat", a "traitor" to the team. A well founded concern. For as history shows, the life span of whistleblowers have is extremely short.

The external auditor also might not jump at the opportunity to report something not so nice about his colleagues. Because of all the above. Because it would negatively impact his relationship with the Chief Audit Executive. And because the Chief Audit Executive might play tit for tat and say something nasty about him. It could wind up as a lot of inconclusive squabbling with the word of one professional confronting that of another. Why bother?

The company also won't be hot to trot. Because if it presses charges, the ensuing court case - if it is contested - might open cans of worms they would rather keep shut. The most likely solution will be a hushed internal handling. Thus the most likely candidate - some may call it the last resort - to file a complaint is the profession. It has the power, knowledge and motivation. To protect and enhance the credibility of the profession as a whole. With that triple punch, it hardly seems possible to go wrong. But think again. For up to now the IA profession in The Netherlands has done nearly nothing to enforce its rules and regulations.

Discussion on Scope of Services

Table 5-13 IA's Scope of Services: Case Study Results Compared With Tentative Conclusions from Theory[81]

	Conclusions derived from Agency Theory and Transaction Cost Economics				
	Scope of Services	**IBG**	**BNG**	**TPG**	**AA**
14	Transaction Cost Economics predicts that it is preferable to broaden IA's scope of services.	++	++	0	++
15	IA's scope of services is broader than just Financial Audit, which provides a unique selling point when compared with the external auditor.	++	++	0	++
16	The way the Management Board operates should be within IA's scope of services.	0/+	--/+	-/+	--/+
17	The incentives/appraisal system is part of IA's scope of services.	-/0	-/0	-/0	-/0
18	The higher the need for specialized knowledge of the organization the sooner IA will be involved in the external audit.	-/0	-	+	--
19a	IA can be used as an instrument to reduce the cost of the external audit.	0	0	+	0
19b	IA can be used as an instrument to support management control.	+	+	+	+
20	From a cost efficiency perspective, coordination with the external auditor is needed.	+	+	+	+
21	Due to Corporate Governance developments, the need for coordination with the external auditor will increase.	++	++	++	++

We will discuss them in the order of the table above.

[81] The scale that is used varies from ++ (very much so, strongly supported) to -- (not supported at all). 0 means that they are more or less indifferent and ? means that no conclusion can be drawn based upon the findings in the case study. NA is not applicable, meaning that in this particular case this was not an issue.

(14) Transaction Cost Economics predicts that it is preferable to broaden IA's scope of services. (15) IA's scope of services is broader than just Financial Audit, which provides a unique selling point when compared with the external auditor

Transaction Cost Economics indicates that it is best to expand internal audit into a broader function than merely financial audit, because more value can then be created. This prediction is very much supported by the case studies. Over the last decade - with the exception of TPG - the traditional financial audit was made the sole responsibility of the external auditor, Meanwhile, IA focused on operational audits and other consultative areas. Other services were included in its scope, such as risk management services, quality initiatives, and environmental auditing.

What was the driver for this development? Part of it was certainly the profession's urge to profile itself as adding more and more value. Being perceived as "management aids" etc. But there might be other factors at work as well. For example, high Asset Specificity might have promoted - or at least supported - the bundling of more and more knowledge and skills among auditors in particular and IAF's in general. Another interesting and, indeed, exciting, question is whether IA bit off more than it can chew. If like a company expanding too quickly it has promised more than it can deliver.

Although there is a certain turning back of the clock towards financial auditing, no one thought this would be totally reverse the developments of the last decade. Yes, Sarbanes-Oxley and similar Corporate Governance initiatives require more focus on the reliability of financial reporting. And that impacts both IA and the external auditor. Nonetheless, board members as well as Chief Audit Executive's indicated - not only in the interviews, but also via the survey questions - that they needed of other assurance services as well. Such as audits focused on fraud, ethics, risk management, quality, change management, and compliance.

(16) The way the Management Board operates should be within IA's scope of services. (17) The incentives/appraisal system is part of IA's scope of services.

Although "tone at the top" is a crucial element of an organization's management control system (see Chapter 4), and, therefore, should be included in IA's scope of services, the top itself has other ideas. Management Board members not only do not relish the impertinence of IA scrutinizing them, they are absolutely opposed to it. Some Audit Committee members sort of support the broad notion. But when it gets down to the brass tacks of how to make it a reality, the logic rather quickly gets a lot fuzzier. Thus they
expect Chief Audit Executive's to report to them any "undesirable behaviour" and breaches against codes of conducts on the part of top management, but resist having such responsibilities and powers written into the Audit Charter. It is up to the Chief Audit Executive himself to draw up protocols that will empower him to operate in this minefield.

You don't have to be the Delphic oracle to imagine the following scenario. If the Chief Audit Executive detects some unsavory management behaviour and that is latter vindicated by the company, stockholders, press and public at large, then the Audit Committee members will claim they were behind him all the way. If, on the other hand, things go otherwise - or not as sensationally quick as it happens in the movies - then they might cut him loose to struggle and go down on his own. Which reminds me of Napoleon's famous saying. "Success has many fathers. Failure is an orphan."

The area of the incentives and rewards - essential elements in any management control system and ways of steering behaviour - is also murky. Some interviewees were rather indifferent about having this included in IA's scope of services. Others were more or less opposed. For the Management Board, this might be a question of IA breathing too close to its neck. Besides, it's not necessary. This is something Remuneration Committee of the Supervisory Board is perfectly capable of taking care of. How they will make sure that incentives and rewards are applied correctly is not elaborated. Theory in this area is not (yet) corroborated with what is happening in real life.

(18) The higher the need for specialized knowledge of the organization the sooner IA will be involved in the external audit.

This is another area where theory and practice differ. We already noted in section 5.5.1 that specialized knowledge on the part of the audit staff was one of the reasons to have an in-sourced IA. Nevertheless, high scores on Asset Specificity pertaining to 'specialized knowledge[82]' do not corroborate with an involvement in the external audit, again the exception being TPG.

(19b) IA can be used as an instrument to support management control.

All case study organizations acknowledged that IA is an important instrument to foster management control.

(19a) IA can be used as an instrument to reduce the cost of the external audit. (20) From a cost efficiency perspective, coordination with the external auditor is needed. (21) Due to Corporate Governance developments, the need for coordination with the external auditor will increase

The use of IA to reduce the cost is supported by TPG and IB Groep. But not by ABN AMRO and BNG.

During the major shift in IA's scope of services over the last decade, its relationship with the external auditor changed. IA focused mainly on operational audits and the external auditor focused on the financial audit. The clear distinctions between those types of translated into a better idea of who was doing what. The results were a less competitive and easier - if somewhat remoter - relationship. A love/hate relationship - or possibly a hate/tolerate one - smoldering under the surface. But with the increased need for the financial audit to be the best it can be, there is a renewed blurring of the boundaries between internal and external audit. And something more is called for than "peaceful coexistence". In other words, intensified contacts, sound coordination and frequent alignment. These sorts of developments are envisioned by all interviewees.

5.6 Overall conclusions

The case study scores on Transaction Cost Economics's Asset Specificity are more compelling than those on Agency Theory's Information Asymmetry, and thus the rationale to have an IAF - specifically an in-house one - appears to be better supported by one than the

[82] 'Specialized knowledge' is one of the attributes of Asset Specificity as was shown in Chapter 4.

other. Asset Specificity also plays a role when it comes to increasing the scope of services and, therefore, the number of IA staff. But the latter conclusion can't be stretched too far. Because all the case study organizations came complete with an in-house IA - by definition. That's why I studied them. What is surprising, however, is that none of them have considered, or are considering, the possibility of not having IA or outsourcing it (see also Paape 2005a, and Paape et al, 2005b).

Theory and practice also line up as far as how to monitor IA. Almost without exception, the instruments recommended by the former are present in practice. One of the exceptions to that rule is performance based incentives for the Chief Audit Executive. The reason for that is the perceived negative impact on Chief Audit Executive independence. This downside, which has a great deal of merit to it, could be limited by using metrics linked to specific IA targets rather than the performance of the company as a whole. In that respect I would say that theory is valid and practice is lagging behind.

Another exception is credible disciplinary powers enforced by professional bodies.
True, such disciplinary powers and procedures are written into the guidebooks. But they are very rarely applied. In other words, they are shooting with blanks and thus lack all credibility.

The coordination between theory and practice about organizational position is at best dubious. Agency Theory favors a position for IA as close as possible to the principal. Thus in our case studies, the Supervisory Board/Audit Committee, or their equivalent. However, what we find on the ground is a completely different reality. That is, IA remaining in its traditional role as agent of the Management Board - itself an agent - and not likely to budge from that behind the 8-ball position in the near future. In fact, in one of our case studies, it was clearly stated that should IA become the tool of the Supervisory Board/Audit Committee, then top management would create its own separate IA.

True, there is movement in the direction of Supervisory Board/Audit Committee members becoming increasing and more directly involved in the care, feeding and grooming of IA. They have contact with the Chief Audit Executive. In many cases without the Management Board being present. They also need to be involved in planning and discussing the outcome of IA reports (see Chapter 4), and expect to participate in the hiring, firing, and appraising of the Chief Audit Executive. However, at the end of the day one wonders how much of these changes are driven by circumstances and how much by Corporate Governance regulations. In other words, the perceived needs of the players in the real world and the perceived needs of investors, regulators and the public at large.

What about the perceived rationale of IA? How much of it is positive? We need IA to help us, say, increase efficiency and reduce fraud. It is an instrument that has more than once demonstrated its value and has become part of the woodwork. And how much is negative and defensive? We need IA to at least demonstrate to the Supervisory Board/Audit Committee, investors, regulators and the public at large that we did everything we could when things go terribly wrong. An insurance premium against potential blame and claims.

While no one was directly asked these sorts of questions and no one brought them up voluntarily, there were some hints of nervousness among Supervisory Board/Audit Committee members. Namely, that they might be subject to law suits and worse if disaster struck and, therefore, they needed all the assurance they could get. Audit Committee members tend to expect that IA should and will report to them any cases of observed dysfunctional behaviour and breaches against applicable codes of conduct by top management. In other words, the so-called tone at the top audit should be part of its scope of services. However, Management Board members don't see themselves as falling under IA's purview.

Intriguingly, the results shown above were rather consistent over the case studies. There were differences in size and industry; nevertheless that did not make a lot of difference. Based upon this research my answer would be that an IAF is often taken for granted and almost self-evident in the eyes of Management Board and Supervisory Board members. An IAF is valued in different circumstances, apparently having demonstrated its rationale to such an extent that no one is disputing its existence and value.

Chapter 6 Survey; Method and Results

6.1. Introduction

This research started off with a tour de horizon of the status of Internal Audit. Internal Audit was positioned in Chapter 2. The next Chapter studied what happened during the last decade with regard to Corporate Governance and with special attention looked for areas where Internal Audit was addressed. It turned out that Internal Audit was called to the fore and needs to step up to live up to the expectations and to claim their rightful place in the Corporate Governance space. To be able to have some firm ground to stand on and be able to withstand the whims of those in charge or the waves of change, theory was deemed needed. Therefore, we turned to more widely known and often used Agency Theory and Transaction Cost Economics to search for clues and, if possible, building blocks; they were summarized at the end of Chapter 4. And yes, there were quite a few building blocks although not as conclusive as hoped for.

To strengthen theory, a number of case studies were done to get a better grip at real life of Internal Audit during the last decade. The results were elaborated in the previous Chapter. The comparison of available ideas from theory and the conclusions of the case studies led to conclude that there were a number of results which underpinned a number of building blocks and clues of theory.

To delve deeper into the generalizability of our findings and test some hypotheses a survey was developed. The survey aimed at acquiring deeper insight in the whereabouts of Internal Audit and directions it is heading. Methodological triangulation between case study and survey methods is assessed by Modell (2005). He welcomes triangulation of case study and survey methods to find a more balanced fashion within coherent research programs to enable a broader range validity threats to be addressed.

This chapter consists of three distinct parts: The first part deals with testing a number of hypotheses; the second part provides a number of descriptive statistics. The last part shows the results in the perspective of the Corporate Governance issue so widely elaborated in the previous chapters and the starting point of this thesis.

This chapter starts off with an elaboration on the set up, the what, and the how of the survey.

6.2 Survey: Approach and Application

6.2.1 Why a survey?

The diversity of the phenomenon Internal Audit and the IAF's in practice, underscored by the findings of the case studies, combined with the lack of sustainable and clear cut theory, created the need to get some quantitative data to back up the findings and to enhance theory building. To this end the preferred solution is a survey. The survey was mainly explorative and descriptive in nature, aimed at gaining deeper insight in developments of IAF's due to changes in Corporate Governance regulations during the last decade and obtaining some hints about the near future of Internal Audit in general and the IAF in particular. The results would at least show the current situation of Internal Audit and IAF's in the Netherlands in general. It also provides some clues for decision makers when being confronted with a perceived need to have an IAF or being forced to think about an IAF in the realm of the Corporate Governance regulations. In some cases it might even be pressure from Supervisory Board members, or parent companies, and sometimes even colleagues and competitors asking: “Don’t you have an IAF? Why not, if I may ask?”

6.2.2 What is the survey about?

Widener and Selto (1999) surveyed 600 randomly selected Compustat firms with more than 500 employees in the United States. They hypothesized that the Transaction Cost Economic factors Asset Specificity, Uncertainty, and Frequency[83] would impact the ‘Make or Buy’ decision of internal audit in organizations. Their study claimed that firms with high Asset Specificity scores for Internal Audit activities indeed internalize Internal Audit sooner than others. As to Uncertainty, their hypothesis was not supported meaning that Uncertainty was not an explanatory factor for the ‘Make or Buy’ decision. Frequency on the other hand, had some merits explaining the Make or Buy issue. However, the qualitative part of their study showed that Asset Specificity was by far the most contributing reason for having an IAF internally. Also (Behavioural) Uncertainty and strategic needs were determinants of outsourcing. Frequency on the other hand was then rarely cited as the basis for Internal Audit sourcing. Frequency was found to be related to archival measures of size and how often Internal Audit Services were demanded. Widener and Selto (1999, p 66) concluded that: “It is plausible that Asset Specificity is a major driver of the decision to outsource Internal Audit, both from out-of-pocket and opportunity cost perspectives.” Frequency, especially when interacting with high Asset Specificity also seemed to be a plausible driver. Their regression model explained 53% (adjusted R^2=0.46) of the variation in outsourced internal auditing.

There were a few limitations to their research. First, their survey was geared towards measuring Asset Specificity of the Internal Audit activities predominantly. This seems a major limitation because their survey showed that indeed Internal Audit activities had a high level of Asset Specificity but that in itself doesn’t tell the whole story. It is my conjecture that because the organization has high levels of Asset Specificity, Internal Audit activities will consequently show high levels of Asset Specificity as well. Furthermore, it may very well be that Internal Audit activities do have an inherent high level of Asset Specificity due to the fact that specialized training and knowledge is required, the use of proprietary information (as shown in Widener and Selto (1999)), and therefore already contain a high degree of what is called ‘human Asset Specificity’. It is the well-known chicken-and-the-egg problem. Measuring Asset Specificity of Internal Audit activities may be less contributing to the explanation of the ‘Make or Buy’ issue than measuring the Asset Specificity and Information Asymmetry of the organization it is part of. In this survey we aimed at measuring Asset Specificity of the organization as a whole. Section 6.2.3 discusses this issue.

A second limitation of the Widener and Selto (1999) survey was the quality of their measures. They also doubted the reliability of the Uncertainty measures. The third limitation is the relatively small sample size. A response rate of 14% (83 out of 600) may not have been convincing. They could not find any major industry effect with the exception of Wholesalers but there were only 3 represented in their usable sample. And last but not least, their study was limited in geography because it was based in the United States and therefore might not be applicable in other territories. In this context note that the United States has a prevailing one-tier system as opposed to the two-tier environment in The Netherlands. Last but not least,

[83] See Chapter 4 for an explanation of these three concepts.

their data originated in 1996 and by the time of my research some 8 years old. During this period, significant changes occurred in the Corporate Governance landscape as shown in Chapter 3, which of course might have had their effect.

In the present study only parts of the Widener and Selto (1999) study were used to investigate whether their findings are corroborated by the Dutch Internal Audit environment and are still valid some 8 years later. Several adjustments were made. First, as shown in Chapter 4, Asset Specificity has indeed been shown to be the most powerful indicator of the Make or Buy decision. Widener and Selto contributed to that conclusion on the part of Internal Audit. Uncertainty and Frequency were excluded for two reasons. One of them is that Uncertainty did not deliver any support in the Widener and Selto study and they were not sure about the reliability of their measures. Furthermore, the case studies of Chapter 5 showed more promising numbers for Asset Specificity then they did for Uncertainty and Frequency. The decision to exclude Uncertainty and Frequency were backed up after drafting and execution of the survey by three other studies. One study was done by David and Han (2004), one by Carter and Hodgson (2006), and the last one by Boerner and Macher (2006). Their specific findings will be discussed in section 6.2.3. The study done by Van Elten (2005) using the Widener and Selto questionnaire also concluded that Uncertainty did not provide support for their hypothesis that Uncertainty explained the make or buy issue. Frequency however – though less convincing – provided some support. Therefore, it was decided to focus on Asset Specificity solely and to research whether the Widener and Selto findings hold 8 years later and in a different territory and culture and not the least also in a two-tier environment as opposed to the one-tier environment in the United States. Finally I intended to take a look at industry effects as well. Since Widener and Selto were not able to find any it would be nice to be able to further our knowledge if we could get some clue as to the existence of these effects.

A high degree of Asset Specificity requires Internal Audit to acquire deep knowledge of the organization and therefore to in-source an IAF. This knowledge is best acquired via learning-by-doing and being part of the organization. Furthermore, an external provider would need to bear significant costs for training and sustaining firm specific auditor knowledge which would only be acceptable if the contract has a longer term horizon to enable to recover the investments. Not only would any organization be reluctant to underwrite such a contract because it would be difficult to specify the terms of the services rendered and foremost, it would also be difficult to ascertain whether those investments were made. Who is going to exercise oversight on behalf of the organization? One needs to be a professional to be able to assess the proper execution of the contract anyway. If such a contract would be 'incomplete' by nature the possibilities to be subject to opportunistic behaviour would be manifold. On the part of the outside provider such a contract would lead to significant opportunity losses if it was ended before initial costs would have been recouped.

Hypothesis 1 therefore is as follows:

Hypothesis 1:
If Asset Specificity of an organization is high, this will be positively associated with an in-sourced IAF and negatively with outsourcing.

Secondly, since the Widener and Selto (1999) study – and others (see below) - already indicated that Asset Specificity explained the Make or Buy decision, it was decided to study whether their conclusion held in the Netherlands in some more detail. To that end we investigated whether there is a relation between the degree of Asset Specificity of the organization and the size of the IAF and the breadth of the Scope of Services. Therefore, we needed to get as much participating organizations in this survey that do have an IAF rather than sending it to a sample of all organizations. The next sections elaborate on how this goal was achieved.

As shown in the previous Chapters, there are no conclusive clues as how large the IAF should be. There is some understanding that the size of the organization will impact the numbers of the IAF. The same is supposedly true for the industry; Financial Services companies do have large IAF's. But, would Asset Specificity also tell us how large the IAF would be? Would the degree of Asset Specificity be associated to the staffing of the IAF and thereby provide some kind of metrics that would allow for organizations to 'calculate' how large the to-be internalized IAF should be or at least benchmark the size of their existing IAF? Based upon the earlier findings of this research study it was assumed that increasing degrees of Asset Specificity will also lead to increasing staff numbers for the IAF. Due to idiosyncrasy, organizations that do have high degrees of Asset Specificity will most likely need not only more specialized skilled auditors and this knowledge will need to be contained not only within the IAF but also within the organization, but foremost this idiosyncrasy might have an increasing effect on staff numbers as well. More specialized and skilled auditors maybe less easily brought in for other audits for two reasons; first of all their expertise needs to be exploited to their full potential and therefore need to be geared towards their main area of expertise; secondly, they might be rather useless for other purposes due to the lack of specialized knowledge in other areas. These factors might drive staff numbers. Therefore:

Hypothesis 2:
If Asset Specificity of an organization increases, staff numbers of the IAF increases as well.

As Widener and Selto (1999) pointed out that the Scope of Services of the IAF might be related to the:
1. Highly specialized knowledge (and therefore Asset Specificity) needed to perform internal audits; and
2. Strategic demand for their services.

The idiosyncratic use of Internal Audit is also demonstrated quite clearly in Chapter 5. The abundant number of different audit types might also be explained by the degree of Asset Specificity of the organization they are part of. The almost perfect split between Internal Audit and the external auditor in 3 out of the 4 case study companies, whereby the external auditor focused on the financial audit and the IAF on other audits, predominantly operational and IT audits, is exemplary in this respect. The, at least supposedly, commodity financial audit type is done by the outsider and the rest by the insider.

This shift during the last decade may have had an impact on the possibility of the IAF to gain stature and deepen their knowledge of the business and thereby becoming increasingly involved in the strategic realm of the organization thus supporting the conjecture of Widener and Selto (1999, p 67) '….that if Internal Audit personnel wants to stay within the firm they should become more central to the management and day-to-day control of strategic assets and less concerned with more generalized services that can be outsourced easily'. That argument was already made by Ratliff and Beckstead (1994). This development might have fostered the need for their services, not only increase their numbers, but foremost impacting the number of different audit types and thereby the breadth and reach of the IAF services. In other words, might the degree of Asset Specificity also be related to the Scope of Services of the IAF?

The previous paragraph elaborates on the need to have specific knowledge of the organization, creating more specialized auditors that need to be exploited to their full potential and might be – perhaps in some way – be rather useless for other types of audits. This effect might reiterate in the way described in Chapter 2 where we applied the 'unbundling' model (Matthyssens et al, 1998). This model was then used to offer some explanation why internal audit sought to expand its services beyond standardized audits such as financial audits. This model might also offer some clues to the breadth of services.

If Asset Specificity is high and deep knowledge and expertise is called for, specialized auditors will be recruited and predominantly in-sourced. Outsiders are not only more expensive but their knowledge will be lost as soon as they no longer render their service to the organization. Furthermore, the availability of their services will allow the 'buyer/user' to become experienced and – taking that the services are rendered to the satisfaction of the Management and the Supervisory Board – create a buy impulse which may also foster the need to explore other areas as well. If this 'pull' wouldn't be spontaneously, a specialized and skilled audit force may very well be able to apply a 'push' strategy (see Chapter 4). This situation might explain what Power (1996, p 312) once called the 'reproducing' of all kinds of audits.

Therefore:

Hypothesis 3:
If Asset Specificity of an organization increases, the Scope of Services of the IAF will be broader.

Until now we have build solely on Transaction Cost Economics and the dominance of Asset Specificity. Now let us take another look at Agency Theory. As shown in Chapter 4, the dominant idea behind Agency Theory is Information Asymmetry. Information Asymmetry founded either on 'hidden information' or 'hidden action'. In any case, principals are in need of a monitor to exercise some kind of oversight over their agents. In this respect, there might be some similarity with the Asset Specificity case made above that if Information Asymmetry is high or increased similar effects might occur.

Higher levels of Information Asymmetry might induce more anxiety on the part of the principal and mutatis mutandis lead to an increased need to have an Internal Auditor at hand to close the information gap. Now, the question would be does that need to be an in- or an outsourced IAF? Clearly, there might not be an easy answer. It is my conjecture that if Information Asymmetry is high, there will be a need on the part of the principals to be informed on a more frequent basis to close the gap. The higher the level of Information Asymmetry the higher the frequency of using an auditor will be. Although we did not include Frequency as a contributing factor of the Transaction Cost Economic perspective, Frequency in relation to Information Asymmetry (and thus Agency Theory) might still be of importance.

As discussed above, Widener and Selto (1999) showed that Frequency did have an effect on the outsourcing issue, especially in conjunction with Asset Specificity. The very same could be true for Information Asymmetry in conjunction with Frequency. In this study there is some belief that there is a relation between Information Asymmetry and Frequency. The higher Information Asymmetry, the more likely it will be that there is a more frequent need for audit services. And, if there is a more frequent need due to Information Asymmetry, the more likely it will be that the internal audit activities are going to be in-sourced. Economies of scale are also applicable for internal audit services. Furthermore, the case studies revealed that in these organizations outsourcing had not been an issue at all. Foremost, this was due to lack of knowledge of the organization and the culture and people on the part of outside providers. Cost was not really an issue, availability far more. Apparently there was a high perceived need to have an in-sourced IAF in the first place.

The above line of reasoning might hinge around the Frequency issue that for this part might also be closely intertwined with Information Asymmetry. What comes first? Might it be that Information Asymmetry is in some way connected to Asset Specificity as well? If there is a high degree of Asset Specificity will that create also Information Asymmetry, or vice versa? If assets are highly specialized Transaction Cost Economics will conclude that the information needed to conclude any contract will be more difficult to get. Bounded rationality is even more bounded and contracts are definitely be more complex and thus by definition 'incomplete'. Speklé (2001b) pointed out that in case of high Asset Specificity together with a high level of what he calls 'ex post information impactedness' – synonym for Information Asymmetry – 'Boundary Control' is the last resort. Boundary Control is a least desired corner of the play ground[84] from a control perspective. What remains are prescriptive codes of conduct and boundary systems, strict budgets, and tie in of agents through 'hostages'. He then provides another indicative characteristic of the Management Control archetype including 'external audit'. Now, if external audit might be some kind of solution to this problem from the perspective of the outside principal, then we can very well envision Internal Audit being some kind of solution from the perspective of the inside principal overlooking managers below him. In the remainder of this research Asset Specificity and Information Asymmetry will be treated as two distinct factors that do not interrelate and are measured differently. Below the way they are measured is explained.

Concluding, stepping on the Asset Specificity argument and the argument made above:

Hypothesis 4:
If Information Asymmetry within an organization is high, then in-sourcing of the IAF is higher and outsourcing of the IAF lower.

And, mutatis mutandis;

Hypothesis 5:
If Information Asymmetry of an organization increases, staff numbers of the IAF increases as well.

As to the Scope of Services, Information Asymmetry could have the following effect. If there is a high degree of Information Asymmetry the 'principal' is in need of Internal Audit. If this is the case, the IAF will be in-sourced and bigger sized if Information Asymmetry increases. However, the breadth of the Scope of Services will be more depending on the level of Asset Specificity as described above, due to the specific knowledge to execute the audits. Information Asymmetry as such may not necessarily have an effect on the breadth of the Scope of Services. On the contrary, the principal-agent Information Asymmetry calls for reliable information aimed at unveiling both hidden information and hidden action. This closing-the-gap will predominantly be done using all kinds of reports. Those reports need to

[84] "This condition implies a seriously limited possibility to define and evaluate performance, even after the contribution has been made" (Speklé, 2001, 90)

be audited and predominantly contain (financial) data. This would require financial audits, creating a narrower Scope of Services. Therefore,

Hypothesis 6:
If Information Asymmetry of an organization increases, the Scope of Services of the IAF is narrower.

Although, Asset Specificity and Information Asymmetry are dealt with separately, it is obvious that their effects show congruence as to the Make or Buy issue and the size of the IAF. Since it was already noted that there may be some kind of reinforcement effect:

Hypothesis 7:
Combined high scores of Asset Specificity and Information Asymmetry yields more in-sourcing of the IAF.

And

Hypothesis 8:
Combined high scores of Asset Specificity and Information Asymmetry increases the size of the IAF.

6.2.3 How the survey was conducted

Surveyed organizations and response

The present study aimed at inventorying 100% of organizations in The Netherlands having an IAF. Although it is hard to guarantee the 100% mark has been achieved it must be pretty close. The process depicted below will demonstrate the basis of this conjecture.

The process was as follows:

1. Membership lists of the IIA The Netherlands, the Royal Dutch Institute of Chartered Accountants (NIVRA), the 'Vereniging van Operational Auditors' (VRO), and the 'Nederlandse Organisatie van EDP Auditors'(NOREA; the IT auditors association) were obtained. Those registers contain all members having either a qualification of RA (NIVRA) or RO (VRO) or RE (NOREA) or associated members (CIA's or otherwise qualified as internal auditor);
2. The data of all listed companies (224 by the end of 2003) in The Netherlands was gathered via Euronext, the stock exchange in Amsterdam and all Chief Audit Executives of those companies were gathered via Step 1 or by calling upon the company or using publicly available data via the internet;
3. A list of all companies having revenues exceeding € 100 million – approximately 1700 – according to the data provided by the joint 'Chamber of Commerce' was obtained. The list was shortened by excluding companies that were subsidiaries of Dutch companies, or subsidiaries of foreign listed companies (like Texaco for instance, that have their Chief Audit Executive abroad) or just 'special purpose vehicles' of parent companies. Furthermore, all companies that were merely 'holding companies' based in The Netherlands for mere fiscal reasons were excluded as well since they do not have any personnel and most surely no IAF either. The remaining companies were compared with the companies obtained in Step 1 and 2;

4. Companies for which it was not yet known whether or not an IAF was present were checked via websites and the internet. If that was not possible or did not provide sufficient evidence they were contacted via phone. If it was not possible to get a conclusive answer the company was included in the list. The number of organizations that was included in the survey via steps 1 to 4 was 228;
5. Data of Public Services organizations was gathered via public registers supplied by Governmental agencies or organizations and contained:
   a. Ministries and their Departmental Audit Services; in this case 12 Ministries were selected;
   b. Large municipalities exceeding 100.000 inhabitants that might have an IAF; selected by using public available data from the government. In this case 15 were selected;
   c. Provinces and their Audit Services. In this case all 12;
   d. University hospitals. In this case all 8;
   e. Universities and 'Higher Educational Schools'. In this case 20;
   f. 'Zelfstandige Bestuurs Organen' (autonomous administrative authorities which perform a public task without falling directly under a Minister); and 'Agentschappen' (agencies) of the government. In this case 24 were selected. Whether or not they had an IAF was checked via the available data as well and if no conclusive answer was obtained called upon or included as well;
6. Using my extensive network, the available data of the Erasmus University, colleagues and competitors – if available - , holding data of students, staff, employers, and Chief Audit Executives was used as well to check whether any names or addresses were missing. On two occasions addresses 'popped up' via ads in the newspaper, via executive searchers searching for internal auditors.

The end result was a list containing 320 addresses of organizations and their Chief Audit Executives or internal auditor(s). Out of this 320 a total of 144 responded. Organizations that did not respond were contacted again to make sure that their reason for not responding was that they did not have an IAF. Through this process it was revealed that 90 of those 176 did indeed not have an IAF.

For calculating the response percentage these 90 was subtracted from the 320 leading to 230 organizations that could have an IAF. We now know that out of these 230 a total of 144 responded; leaving maximum 86 for which we were not able to ascertain whether they had an IAF. Based on Manski's (1990) bounds the response rate will be between 66.6% (see Table 6-2) and 39.7% (see Table 6-3).

Table 6-1: Response rate

	Responded		
	Yes	No	Total
IAF			
Yes	127	Less than or equal to 86	
No	17	Equal to or more than 90	
Total	144	176	320

Table 6-2: Response rate extreme situation 1

	Responded		
	Yes	No	Total
IAF			
Yes	127	86	213
No	17	90	107
Total	144	176	320

In this case the response rate would be 66.6% (213/320).

Table 6-3: Response rate extreme situation 2

	Responded		
	Yes	No	Total
IAF			
Yes	127	0	127
No	17	176	193
Total	144	176	320

In this case the response rate would be 39.7% (127/320).

Furthermore, an abridged version of the survey was send to Management Board Members as well as Supervisory Board members (see below). Of the 203 organizations that did have an IAF 93 Management Board members responded (46%) and 30 Supervisory Board members (15%). For five surveys, no value was provided for the question whether the respondent was either a Management Board or Supervisory Board member and were excluded from the data set.

To reach high response rates the following measures were taken (Van Engeldorp Gastelaars, 1998). The time to complete the survey was kept as limited as possible. The survey for Chief Audit Executives contained 67 questions (see Appendix 6) that would take approximately 30 minutes to complete it. An abridged part of the survey – 17 questions out of the 67 - was also addressed to the Managing and Supervisory Board members (see appendix 7). This would allow comparison of their answers with those of the Chief Audit Executives to see whether there are any discordant opinions. The limited part of the survey would take approximately 5 to 10 minutes.

The two surveys were sent to the Chief Audit Executive (if known), the Officer known to bear responsibility for the audit function, or the Chief Financial Officer or comparable officer. The Chief Audit Executive or comparable officer was asked to pass through the survey to Managing and Supervisory Board members. It was expected that the willingness to cooperate would be increased if a familiar staff member would present it.

Surveys that were not delivered and sent back due to lacking or wrong addresses were followed up and resend. Within three weeks, a reminder was sent to the organizations via email. Incorrect email addresses were sorted out and reminders were sent. This was repeated three times whereby the last two reminders were sent to the respondents personally and not via an undisclosed list of addresses. The latter was done by me or my assistant but in any case using my email box in order to emphasize my personal interest and call upon their commitment to participate. It was hoped for that personal ties and familiarity between many Chief Audit Executives and me would enhance their willingness to cooperate.

At the end of this extensive process a few remaining organizations were called upon personally via telephone to participate in order to even further demonstrate the personal interest of the researcher. Last but not least during occasional personal meetings the personal interest in their response on this survey was underscored.

More important than the non-response rate between 33.4% and 60.4% the systematic bias that can arise as a consequence of non-response (Van Engeldorp Gastelaars, 1998). It was ensured that the non-response was not selective by keeping track of the responses and thereby enabling tracking non-respondents who subsequently were surveyed why they did not complete the survey to make sure that non-response was indeed not selective. 38 Organizations (50% of the total of 76 (203 minus 127)) provided a reason why not. Results were as follows:

- No time (28);
- No interest (3);
- Company policy not to reply (2);
- Reorganization at hand (2);
- Other reasons (3).

Based upon the above it was concluded that the respondents were representative and non-response was not in any way selective.

For the survey analysis only organizations were included that had an IAF. Organizations that did no have an IAF were excluded from the analysis. Therefore, no comparisons were made between those respondents that did and those that did not have an IAF.

First of all an overview of the responding branches of the organizations is shown in table 6-4.

Table 6-4: Overview of branches of respondents

Industry	Number	% responding
Trade, Transport, Logistics	18	16
Production, Energy, Utilities	15	13
Telecom, IT, Media & Entertainment	10	9
Professional Services	5	4
Financial Services	35	30
Public Sector	33	28
Total	**116**	**100**

From the 144 responding organizations 116 usable surveys remained; some 11 missed relevant data. From a Chi-square test it turned out that the over- and under representation of some industries in the survey response is statistically significant. However, this was not considered as a major problem, since the main goal of the survey was to test the aforementioned hypotheses and not to measure population characteristics.

The size of the companies is presented in Tables 6-5 and 6-6.

Table 6-5: Size of responding organizations in turn over

Size in turn over in €		Frequency	Valid Percent	Cumulative Percent
Valid	Less than 50 million	6	4.3	4.3
	Between 51 and 100 million	4	2.9	7.2
	Between 101 and 500 million	32	23.0	30.2
	Between 501 million and 1 billion	29	20.9	51.1
	More than 1 billion	68	48.9	100.0
	Total	139	100.0	
Missing		5		
Total		144		

Table 6-6: Size of responding organizations in total staff numbers

Size in number of staff		Frequency	Valid Percent	Cumulative Percent
Valid	Less than 500	20	14.0	14.0
	Between 501 and 1,000	11	7.7	21.7
	Between 1,001 and 2,500	27	18.9	40.6
	Between 2,501 and 10,000	49	34.3	74.8
	More than 10,000	36	25.2	100.0
	Total	143	100.0	
Missing		1		
Total		144		

From the perspective of staff numbers, the results can be detailed as follows; 14% has less than 500 staff. Not surprisingly, those 20 organizations are to be found in Financial Services industry (11) and Public Sector industry (5) predominantly. The majority of the population has staff between 2,501 and 10,000 (34%) and 25% having staff in excess of 10,000.

Survey design

The respondents had the right to know the objective of the survey and in which setting it took place and what would be done with the results. Therefore, the survey was accompanied by two introduction letters (see Appendix 8), one for the Chief Audit Executive, and one for the Supervisory Board/Audit Committee and Management Board members. This letter explained the objective of the survey, the amount of time it would take and the possibility to call for assistance either via email or via the phone. During the course of the survey two people called for assistance and requested elaboration on the content of the survey.

If needed it was also possible to receive a Dutch version of the survey, 10 requested a Dutch version. The introduction letter also emphasized the confidentiality of data and respondent. It was also possible to ask for a summary of the results. The survey was sent out in hardcopy format with the possibility to receive yet another copy via email. The survey was sent out mid October 2004 and finally the closing date was set at February 28, 2005.

A pilot version of the survey was designed, based upon prior known surveys used by other researchers (Widener and Selto, 1999; see below) and institutes (IIA, 2000). This pilot version was used alongside the case studies and send to members of their Supervisory Board/Audit Committees, Management Boards, and Chief Audit Executives. This version was used to test the design and the applicability of and easiness to understand the questions, unclear or muddled wordings and sentences.

The survey was redesigned and laid out before two experts very familiar with surveys. Upon their comments the draft survey was further adjusted and then piloted with 4 Chief Audit Executives of 4 different organizations. Upon their comments the survey was again – though slightly - adjusted. The survey was also corrected by a native English/American writer and teacher.

To establish the validity of this survey, we consider four kinds of validity (Churchill, 1979; Yin, 1994, 2003; Korzilius, 2000; Johnson and Duberley, 2000; Verschuren and Doorewaard, 2001). Content validity tries to ascertain if all aspects of an idea are measured correctly. Construct validity is about measuring the variables correctly (see below). Internal validity refers to the quality of the conclusions from the research. External validity is aimed at the (possible) generalization of the conclusions for other populations or conditions. The tactics to deal with the validity of the case studies were already discussed in Chapter 5. Above it was already pointed at the triangulation between case study and survey methods and their implications for validity (Modell, 2005). With regard to the survey a number of steps were taken to enhance the validity of the survey even further.

With regard to content validity existing prior research and surveys were used extensively (Chapter 4 and below). A list of all relevant variables that could be taken into account and the process to select those that were included in the final survey has been elaborated in Section 6.2.2.

Construct validity requires correct operational measures for the variables studied. For many of the variables used in the survey this was easy. Size of the company for instance was measured in three ways: turnover/revenues per 2003, total assets per end of 2003, and staff numbers also per end of 2003. The latter was later adjusted for the absolute numbers per end of 2004. This was done via a desk research were annual reports and websites were researched. In cases that those sources did not provide the required number, the organizations were approached via the phone and/or email and kindly requested to provide the staff number per the end of 2004.

External validity is a strong point of any survey. Surveys are renowned for their ability to provide generalizability of the conclusions. The main attribute of a survey though is that the sample should be random. In that respect, this survey has every right to acclaim that external validity is high. The surveyed companies make up for nearly 100% of the total population since all organizations that do have an IAF were included. The steps taken to warrant that 100% score have been described above as well as the response rate and the way non-response was taken care of.

The questionnaire was presented to the Chief Audit Executive who has access to the relevant data of the organization.

Important variables and their definition are given in Table 6-7.

Table 6-7: Variables used in the survey

Variable name	Description	Type	Min	Max	Operationalization
AS	Asset Specificity indicator	Binary	0	1	Constructed out of 12 ordinal 1-5 survey scores
IA	Information Asymmetry score	Continuous	1	4.5	Factor analysis on 5 ordinal 1-5 survey scores
FTE IAD	Size Internal Audit Department 2004 (in FTE's)	Continuous	0.5	800	Survey: Q48 (2004)
PERC OUTS	Percentage Outsourcing IAF 2004	Continuous	0	1	Survey: Q50 / (Q48 + v50) (all for 2004)
AUDIT SCOPE	Scope of Audit Services 2004	Ordinal	1	8	Constructed out of survey Q55 to Q62 (for 2004); (Number of different audit types needed to count for 80% of the total)
FTE TOTAL	Size of organization 2004 (in FTE's)	Continuous	37	350,000	Desk research
NR SUPERV	Number of external supervisors other than the external auditor	Ordinal	1	10	Desk research

The last variable 'total number of supervisors other than the external auditor' requires some elaboration. During the execution of the survey, the researcher was requested to be part of a global team of a service provider that was requested by a large financial services organisation to tender for a proposal in which they called for an overhaul of their global IAF. It turned out that – amongst others - one of their regulators criticized the IAF, which set off the idea of the restructuring effort. During the tendering process, the team had a meeting with the CEO, the CFO, and the Chief Audit Executive to discuss the details of the bid. Once more it came to the attention that the uttering of any regulator matters, especially in a highly regulated environment subject to much compliance drives during the last decade in particular. The CFO asked: "How long will it take to get this overhaul done?" Upon the estimate provided he exclaimed: "And during that lengthy process I will still get those imperative letters by the regulator and discussions at Supervisory Board and Audit Committee meetings! Can't we speed it up a little?"

It then dawned that the possible impact of Supervisors/Regulators in this research should be taken into account. Perhaps the size of the IAF is also influenced by Supervisors/Regulators and the sheer number of them that any global organization might be subject to? Surely their position is influenced by Supervisors/Regulators since they expect the IAF to be as independent as possible. Even the Scope of Services might in some way be impacted by their views. It was then decided to include the number of Regulators and Supervisory bodies in the analysis as envisioned that the more there would be the more this might impact the IAF.

That number was revealed via desk research. Annual reports were analyzed and, if needed, the Chief Audit Executive was called to provide with the number. In some cases it turned out that there could be dozens, especially in Financial Services organizations operating on a global scale. The number of Supervisors was topped at 10. The impact of regulators might be more profound and as such should be researched more in-depth in subsequent studies.

Operationalizing the independent variables

Asset Specificity

Although Asset Specificity is described rather well in literature (Williamson, 1987; Milgrom and Roberts, 1992; Furubotn, 2001; Speklé, 2001b, to name just a few), measuring the degree of Asset Specificity of an organization is not easily done. Asset Specificity is described by Williamson (1996, p59-60) as follows:

> 'Without purporting to be exhaustive, Asset Specificity distinctions of six kinds have been made:
> 1) Site specificity, as where successive stations are located in a cheek-by-jowl relation to each other so as to economize on inventory and transportation expenses;
> 2) Physical Asset Specificity, such as specialized dies that are required to produce a component;
> 3) Human Asset Specificity that arises in a learning-by-doing fashion;
> 4) Dedicated assets, which are discrete investments in general purpose plant that are made at the behest of a particular customer, to which;
> 5) Brand name capital and;
> 6) Temporal specificity having been added.'

Although this description may seem rather self-explanatory, translating that to measurable units is not that easy. Some measured Asset Specificity directly through a five-item scale capturing specific equipment (Mitthas, Jones, and Mitchell, (2003)), others use inter-firm co-specialization (Dyer, 1997; Mudambi et al., 1998; Poppo and Zenger, 1998), labor skills (Walker et al. 1991), business processes (Zaheer et al. 1994), JIT requirements, and product customization (Bensaou et al. 1999). Shelanski and Klein (1995) asked a manager on a scale of 1-5 or 1-7 the degree to which an asset has value in outside uses. As Klein (2004) noted as Asset Specificity cannot be easily measured, some other proxies have been applied such as concentration in single-industry studies to capture situations where small-numbers bargaining situations are likely to appear.

A limitation of these measures is that they are likely to be subjective. For example, for the same objective measure of specificity, a more risk adverse person could report a higher cardinal measure.

David and Han (2004) provided a systematic assessment of the empirical support for Transaction Cost Economics. They selected 63 articles containing 308 statistical test of core Transaction Cost Economics relationships. The Widener and Selto (1999) study by the way was not included in their analysis. Their overall score for the different attributes of Asset Specificity as an independent variable is as follows:

- Human Assets (divided in 9 sub-attributes) scored an average support of 57%;
- Physical Assets (divided in 5 sub-attributes) scored an average support of 55%;
- Human and Physical Assets (as a composite measure) scored an average support of 65%;

- Product (divided in 6 sub-attributes) scored an average support of 91%;
- Site (divided in 2 sub-attributes) scored an average support of 20%;
- Firm (divided in 4 sub-attributes; among them brand scoring 100%) scored an average support of 60%.

The total average support for Asset Specificity was 60% and countered in just 4%. Uncertainty was supported in just 24% and countered in 16%. Frequency, peculiarly, was only researched very little and therefore excluded in their study. Again, their research underpins the choice for focussing on Asset Specificity solely. “As an independent variable, Asset Specificity fared best”. (David and Han, 2004, p52)

One of David and Hans (2004, p52) surprises was that overall support for Transaction Cost Economics was found only to be 47%: “In the meantime, however, our results keep us from unreservedly agreeing that the theory is an ‘empirical success story’ (as acclaimed by Williamson, 1996, p55)”. Again, also in the much acclaimed Transaction Cost Economics theory seems to be room for improvement.

Carter and Hodgson (2006) concluded accordingly:

> ‘This overall picture of partial and qualified consistency with Williamson’s framework contrasts with more upbeat and categorical claims found in some previous surveys of TCE empirical work’.

Boerner and Macher (2006, p38) added even further issues:

> ‘In addition to the problems associated with the use and measurement of transaction cost proxies, a second important gap in the existing empirical literature concerns the endogeneity of transaction cost variables, most notably Asset Specificity. Virtually all of the studies examined in this paper treat the specificity of assets and the level of a firm’s investment in those assets as exogenous’.

Taken all of the above into account 12 questions were developed (survey questions 7 to 15, 19, 20 and 66). Although the survey of Widener and Selto (1999) provided some footing, only one question was copied due to their measuring of the Asset Specificity of the internal audit activities itself instead of that of the organization. Some five questions were applied though slightly adjusted.

The one that was copied was 19 (number 66 in my survey; ‘How long does it take before an internal auditor can perform audits independently?’). The ones that were slightly adjusted were:

- 1 and 23 (number 23 in my survey; ‘Do you have an IAF?’);
- 4 and 5 (number 50 in my survey; ‘Total in-sourced fte’s on an annual basis’.);
- 30 (number 55 to 63; ‘Total time spend on different activities by the IAF’.).

For the full details of the survey questions see Appendix 6.

To measure the degree of Asset Specificity not just the total score of the 12 questions was averaged. An organization may be very well Asset Specific if a number of questions are scored 5 (on a scale from 1 to 5, 5 being strongly agree) and a number of others are scored 1 (being strongly disagree). It was concluded that it would be very much debatable to assess whether an organization would or would not be highly Asset Specific based upon an average score of those 12 questions. Supposedly there could be a few questions out of those 12 that would provide high scores while others might provide very low scores. The average could then lead to the conclusion that the organization would not be Asset Specific whereas there would be distinct reasons that might conclude otherwise. It was decided to use a threshold of at least 3 questions that needed to score the maximum score of 5 to allow for the conclusion that the organization is Asset Specific.

Information Asymmetry

Information Asymmetry is an even more difficult to operationalize. In literature, a lot has been said about Information Asymmetry in the context of difference between the information known to the organization versus the information known to the outside world. Many studies use proxies like the expenditures on R&D, the bid-spread for trading stock, etc. to reveal the level of Information Asymmetry.

This study aimed at Information Asymmetry between top management (Management Board) and lower level management. There were hardly any validated surveys or research available that could be used. Seidmann and Sundararajan (1997) researched Information Asymmetry in relation to business process redesign without providing measures of Information Asymmetry. Jaworski and Young (1992) studied dysfunctional behaviour and management control and related Information Asymmetry to job tension and role-conflict.

They used a 5 point-scale and included the following questions:

1. My manager know exactly how to accomplish the work I normally encounter;
2. My manager is intimately familiar with the day-to-day decisions related to my work;
3. My manager has developed an excellent working knowledge of my job;
4. My manager can quantitatively assess my performance after I complete my activities;
5. My manager is able to adequately assess my performance after I complete my activities;
6. My manager can specify the most important variables to monitor in my work;
7. My manager can specify performance objectives to cover the range of activities I perform.

Fisher et al (2002) studied the effect of Information Asymmetry on negotiated budgets but came up with a kind of dichotomy; they assumed Information Asymmetry was present or lacked in an experiment where superiors did or didn't knew the subordinates' performance capabilities.

Dunk (1993) also relied on a six-item scale to measure the extent of Information Asymmetry between a respondent and his superior. All items use a seven-point anchored Likert scale (1 = I have no information advantage, 7 = I have a very significant information advantage). Bouwens and Van Lent (2006) provided further evidence on the convergent validity of the Information Asymmetry measure by correlating their measure with characteristics of respondents that reflect their accumulated experience and knowledge. As a manager's experience grows, the likelihood that he knows more than his superior increases.

Their questions were:

1. How much better informed are you about the type of activities undertaken in your unit?

2. How much more familiar are you with the type of input output relations inherent in the internal operations of your unit?
3. How much more certain are you about the performance potential of your unit?
4. How much more familiar are you with the technical aspects of the work in your unit?
5. How much better are you able to assess the potential impact on your activities of factors internal to your unit?
6. How much better do you understand what can be achieved in your unit?

The problem with all of the above questions is that they measure the Information Asymmetry on the level of a superior and his ‘agent’ but not on the level of the organization as a whole.

For this survey five questions were developed that could enable some measure of Information Asymmetry. This lead to a continuum of five ordinal questions (questions 16 to 18, 21 and 22). Because Information Asymmetry was less developed in literature I used a factor analysis. The results of the Principal Component Factor Analysis of the Information Asymmetry questions (114 cases used 2 cases contain missing values) is shown below.

Table 6-8: Components loadings for questions measuring Information Asymmetry

Variable	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5
Q16	-0.797	0.197	0.195	-0.357	-0.400
Q17	-0.807	-0.122	0.325	-0.165	0.449
Q18	-0.758	-0.111	0.052	0.630	-0.119
Q21	-0.517	0.435	-0.726	-0.046	0.123
Q22	0.225	0.887	0.364	0.158	0.076
Variance	2.1781	1.0418	0.8051	0.5789	0.3961
% Var	0.436	0.208	0.161	0.116	0.079

The factor analysis shows that those five questions point at one dominant factor including the questions 16, 17, 18, and 21. Question 22 was excluded from the analysis. This question asked for the number of levels between the Management Board and the shop floor; allowing for the following answers; one, two, three, four, and five or more. By nature, this question was a very different one than the rest of the survey. The degree of Information Asymmetry was measured by the average score of those four questions.

6.3 Results

6.3.1 Testing the Hypotheses

Regression analysis was used to test the hypotheses. To study the impact of Information Asymmetry and Asset Specificity on several response variables, one could in principle compute simple correlation coefficients. However, in this case one needs to control for other factors that play a role in explaining the response variables. Therefore, second order partial correlation coefficients are used, because the models formulated in this section make use of two control variables. Although this approach is very similar to multivariate regression, it is important to stress that the focus has not been on building models that forecast the response variables but on analyzing dependencies between variables. This focus is also logical given the fact that the survey is of a limited scope and does not contain enough questions to give a large enough set of variables to build a solid prediction model.

I will use this approach to test the eight statements given in the previous section, using the variables given in Table 6-9.

Table 6-9: Variables used for testing the hypotheses

Variable name	Definition
Outs	Percentage Outsourced Internal Accountancy
Audit_scope	Scope of Services provided by the internal audit function
Fte_iad	Full time equivalents of the Internal Audit Function
Fte_tot	Total Full time equivalents
Superv	Number of External Supervisors
AS	Asset Specificity

Analysis Hypothesis 1

The negative relationship between Asset Specificity and the percentage of the IAF that is outsourced is tested with the following linear regression model:

(1) $$Outs_i = c + \beta_1 * Fte_i + \beta_2 * Superv_i + \beta_3 * AS_i + \varepsilon_i ,$$

In this analysis 101 cases could be used because the other cases contained missing values and where therefore excluded. The R^2 value was 2.5% and the adjusted R^2 0.0%. This indicates the absence of any relationship between the percentage of outsourced internal accountancy and the independent variables and therefore between Asset Specificity and the percentage of outsourcing. This makes it unnecessary to look at a further interpretation of the coefficients. Hypothesis 1 is strongly rejected.

Analysis Hypothesis 2

The analysis of a possible positive relationship between Asset Specificity and the number of IAF staff is performed with the following linear regression model:

(2) $$Fte\_iad_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * AS_i + \varepsilon_i$$

In this analysis 108 cases were available; all other cases contained missing values. The R^2 value was 67.6% and the adjusted R^2 66.7%. Furthermore the analysis of variance shows an F-value of 72.33 (P-value = 0.000), which indicates that the combined explaining power of the independent variables is significant more than zero. The following table shows the results of this analysis.

Table 6-10: Results Regression 2

Variable	Coefficient	P-value
Constant	-75.00 (9.862)	0.000
Total Fte (x 1000)	0.7712 (0.1411)	0.000
Number of External Supervisors	40.211 (3.463)	0.000
Asset Specificity	24.74 (12.49)	0.050

All three independent variables have a positive influence on the number of IAF staff and are significant at a 5% level. If an organization is Asset Specific (AS indicator is equal to 1) we are expecting the size of the IAF to be about 25 FTE larger compared to a non Asset Specific organization (AS indicator 0).

From the adjusted R^2 statistic we learn that 66.7% of the variation within the size of the IAF can be explained by this regression. Although this number might not be viewed as a very high number, Anderson et al[85] (2005, 237) stated:

> "In contrast, (*to hard sciences that is*) in the social sciences, where information is often less precise, it is not uncommon for the analyst to consider a solution that accounts for 60 percent of the total variance (and in some instances even less) as a satisfactory solution".

An investigation of the heteroscedasticity revealed that for the small number of institutions with large IAF's, the residuals tend to be larger than for the other institutions. Traditional methods to overcome heteroscedasticity, such as using transformations, relative values and/or additional control variables, did not work in this case because of the unbalance in the sizes of IAF's considered in the sample and the anonymity of the respondents, which complicates adding other control variables to the model. However, given the fact that the regressions models have only been used as means to compute the second order partial correlation coefficients between the size of the IAF and Asset Specificity and/or Information Asymmetry, heteroscedasticity is not considered a major issue here, because, even in the case of heteroscedasticity, the estimated coefficients, the so-called sample statistics, in the regression model (in this case the partial correlation coefficients) are still unbiased and consistent[86].

[85] Anderson, R.E., Babin, B., Black, B., Hair, J.F., and Tatham, R.L., (2005); Multivariate Data Analysis, 6th Edition, New York, Prentice Hall

[86] A sample statistic used to estimate a population parameter is unbiased if the mean of the sampling distribution of the statistic is equal to the true value of the parameter being estimated. A sample statistic is consistent if for larger sample sizes the statistic converges to the true parameters.

The conclusion is that Hypothesis 2 is supported by the regression results. The null hypothesis that the coefficient of the AS indicator is smaller than or equal to zero can be rejected at a five percent significance level. The type I error (the probability that this hypothesis is wrongfully rejected) is equal to 0.025.

Analysis Hypothesis 3

The possible positive relationship between the Scope of Services of the IAF is tested in the following linear regression model:

$$(3) \qquad Audit\_Scope_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * AS_i + \varepsilon_i$$

In this analysis 105 cases were available; other cases contained missing values. The R^2 value was 3.9% and the adjusted R^2 1.1%. This indicates the absence of any relationship between the Scope of services of the IAF and the independent variables, including the Asset Specificity. From these results one can conclude that hypothesis 3 should be rejected.

Analysis Hypothesis 4

To test the negative relationship between the Information Asymmetry within an organisation and the percentage of the IAF that is outsourced the following linear regression model is used:

$$(4) \qquad Outs_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * IA_i + \varepsilon_i$$

In this analysis 106 cases were available; other cases contained missing values.
The R^2 value was 3.3% and the adjusted R^2 0.5%. This indicates that there is no relationship between the percentage outsourced and the independent variables, which leads to the rejection of hypothesis 4.

Analysis Hypothesis 5

In order to test on the presence of a positive relationship between Information Asymmetry and the number of staff of the IAF, the following linear regression model is used:

$$(5) \qquad Fte\_iad_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * IA_i + \varepsilon_i$$

In this analysis 113 cases were available; other cases contained missing values. The R^2 value was 67.2% and the adjusted R2 66.3%. Furthermore the analysis of variance shows an F-value of 74.50 (P-value = 0.000), which indicates that the combined explaining power of the independent variables is significant more than zero. The following table shows the results of this analysis.

Table 6-11: Results Regression 5

Variable	Coefficient	P-value
Constant	-105.01 (22.95)	0.000
Total Fte (x 1000)	0.7759 (0.1388)	0.000
Number of External Supervisors	40.619 (3.399)	0.000
Information Asymmetry	12.975 (7.729)	0.096

All three independent variables have a positive influence on the number of IAF staff members and are significant at the 5% level, except for Information Asymmetry. Information Asymmetry is significant at a 10% level. If an organization has an increasing degree of Information Asymmetry we are expecting the size of the IAF to be about 13 FTE larger compared to a low degree Information Asymmetry organization.
From the adjusted R^2 statistic we learn that 66.3% of the variation within the size of the IAF can be explained by this regression.

Heteroscedasticity was also an issue in this case. However, given the fact that the regressions models have only been used as means to compute the second order partial correlation coefficients between the size of the IAD and Asset Specificity and/or Information Asymmetry, heteroscedasticity is not considered a major issue here, because, even in the case of heteroscedasticity, the estimated coefficients, the so-called sample statistics, in the regression model (in this case the partial correlation coefficients) are still unbiased and consistent[87].

Analysis Hypothesis 6
The negative relationship between Information Asymmetry and the Scope of Services is tested with the following linear regression model:

$$Audit\_scope_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * IA_i + \varepsilon_i \quad (6)$$

The R^2 value was 1.7% and the adjusted R^2 0.0%. This indicates the absence of any relationship between Information Asymmetry and the used independent variables (including the Scope of Services), and therefore leads to the rejection of hypothesis 6.

Analysis Hypothesis 7
Hypothesis 7 states that a combination of high scores on both Asset Specificity and Information Asymmetry yields an extra effect on the percentage of insourcing of the IAF, besides the individual effects of both variables. Because both variables do not have a significant influence on the percentage of insourcing, there will not be an extra combined effect. This means hypothesis 7 is rejected.

[87] A sample statistic used to estimate a population parameter is unbiased if the mean of the sampling distribution of the statistic is equal to the true value of the parameter being estimated. A sample statistic is consistent if for larger sample sizes the statistic converges to the true parameters.

Analysis Hypothesis 8

The positive relationship between combined high scores of Asset Specificity and Information Asymmetry and the number of staff of the IAF is tested by the following linear regression model:

$$(8) \qquad Fte\_iad_i = c + \beta_1 * Fte\_tot_i + \beta_2 * Superv_i + \beta_3 * AS_i + \beta_4 * IA_i + \beta_5 * AS_i * IA_i + \varepsilon_i$$

In this model an interaction term between information asymmetry and asset specificity is included to measure the extra effect of a combination of high scores on both variables. The relationship between Asset Specificity and the size of the Internal Audit Function now becomes:

$$\frac{\partial Fte\_iad_i}{\partial AS_i} = \beta_3 + \beta_5 * IA_i$$

This means the relationship will not be constant as before, but will partly depend on the Information Asymmetry score. Therefore a high score on Information Asymmetry also means a higher positive (or negative) relationship between Asset Specificity and the size of the internal audit function. The same logic applies for information asymmetry. This way the extra effect of high scores on both variables is measured by β_5.

In this analysis 108 cases were available; other cases contained missing values. The R^2 value was 68.7% and the adjusted R^2 67.1%. Furthermore the analysis of variance shows an F-value of 44.74 (P-value = 0.000), which indicates that the combined explaining power of the independent variables is significant more than zero.

Table 6-12: Results Regression 8

Variable	Coefficient	P-value
Constant	-107.19 (23.66)	0.011
Total FTE (x 1000)	0.7782 (0.1404)	0.000
Number of External Supervisors	40.104 (3.443)	0.000
Asset Specificity	22.96 (12.48)	0.550
Information Asymmetry	11.965 (8.005)	0.761
Interaction of Asset Specificity and Information Asymmetry	18.358 (16.197)	0.260

Except for the Total FTE and the Number of External Supervisors none of the variables is significant. This means there is no proof of an interaction effect between Asset Specificity and Information Asymmetry. Therefore there is no extra effect when a company scores high on Information Asymmetry as well as Asset Specificity, which means hypothesis 8 is rejected.

6.3.2 Discussion and conclusions of testing the Hypotheses

In this section the results of the tested hypotheses are discussed.

The results of the tests of Hypothesis 2 and 5 show clearly that there is support for the prediction that Asset Specificity and Information Asymmetry do have predictive power when it comes to the size of an IAF. Such was not demonstrated by previous research and enriches our knowledge about Internal Audit in general and IAF's in particular. These results allow us to help out on the issue of how large an IAF should be. This clearly depends on whether the organization can be qualified as being Asset Specific; to determine that a number of questions have been used that used prior research but may yet need further refining.

Measuring Asset Specificity as such is a tricky endeavour, as shown by prior research, even more so at the level of the organisation. Nevertheless, it is now upon further research to prove the above wrong or to come up with more refined measures.

Regarding measures of Information Asymmetry that are useful within the boundaries of an organization has till now never been developed and no reference to prior research was available. Again, the tests showed that the expected correlation between higher levels of Information Asymmetry and the size of an IAF hold the test. Hopefully, these results will encourage other researchers to use them and bring them further down the road of scientific value.

Although both Asset Specificity and Information Asymmetry have predictive power as to the size of an IAF, Asset Specificity may have more to offer, at least than was previously known. If organizations are Asset Specific this increases the size of the IAF with some 25 staff as opposed to those that are not. This number is almost twice as high as the increase predicted by higher degrees of Information Asymmetry (some 13) and thereby offering a more compelling story, albeit that this research had no continuum to offer to measure Asset Specificity.

No support was found for either the Make or Buy debate or the Scope of Services issue. This is especially disappointing for the Make or Buy debate. Although already compelling conclusions were drawn by Widener and Selto (1999) and Speklé et al (2005), this research did not corroborate their findings albeit that they measured the Asset Specificity of the IA activities.

If trying to come up with some explanations, the first guess would be that their research aimed at measuring Asset Specificity of the Internal Audit activities whereas my conjecture is that no proof is needed since these activities may be inherently Asset Specific. We need to establish a possible relationship between the Asset Specificity of the organisation instead of the IAF. Opponents might state that if an organization has an IAF this is because they are Asset Specific or suffering high degrees of Information Asymmetry. The way out for this would be to survey organizations that do not have an IAF and compare the results with this one. Anyway, if the above results would hold the Make or Buy debate would be prolonged and we might need to look for other clues.

The case studies described in Chapter 5 already showed that the Make or Buy issue never was on the agenda anyway. It seems that there was a widespread need for an IAF and that if this need was present then no question about it: Let's have it on board! The data showed that the mean of the percentage outsourcing was 9.8%; meaning that on average the percentage that used outsourcing was a little below 10% and thereby not an impressive number anyway.

Reasons to outsource some of the Internal Audit activities are to be found in:
- A (temporary) peak in the demand;
- Specific skills that are not available;
- A very limited overall need that would create only a very small audit shop which might not be sustainable on the longer term and would be best met via outsourcing it totally, enabling a situation of 'call if and when needed'.

Looking at the data of my survey there were no organizations that outsourced more than 75% of their Internal Audit activities and just 3 that outsourced more than 50%. The vast majority (34) that used outsourcing did so for far less than 25%. These data supports the idea that once needed the Internal Audit activities are predominantly in-sourced.

An attempt to find a relationship between the percentage outsourcing versus the size of the organization was to no avail; the R^2 was a very low 0.5%; and the adjusted R^2 0.0%.
There was also no significant difference between the percentage of outsourcing and the industry; the R^2 was 3.11%.

The results did not provide any clues for the broadness of the Scope of Services. Apparently, the breadth of the Scope of Services is in no way related to Asset Specificity or Information Asymmetry. Looking back, the rather massive growth of Operational Auditing, Consulting Services, and other audit types in the nineties (see Chapter 2) may be best explained by the tide of the times and the whims of those in charge of the IAF back then. It is hard to envision that those changes could be ascribed to major changes in either Asset Specificity or Information Asymmetry. The framework provided by Matthyssens et al (1998, see Chapter 2) might be even more powerful.

The Scope of Services might also be more affected by regulators; Sarbanes Oxley is believed to foster the return of Financial Auditing as a more dominant audit type for the IAF. The latter is, however, not demonstrated by this survey as will be shown in the next section.

Concluding this section we found support for the predictive power of both Asset Specificity and Information Asymmetry for staff numbers of the IAF; Asset Specificity providing even more provocative numbers than Information Asymmetry. The R^2 values are 67.6% (adjusted 66.7%) and 67.3% (adjusted 66.3%) respectively; indeed convincing data. For the Scope of Services this research doesn't provide any usable clues whatsoever.

6.3.3 Some other notable findings

A survey like this would allow for many tables, graphs, and details. There is a limit and this limit is to be found in what is indeed 'notable' in the realm of this thesis. Below you will find the ones that were considered most notable and sometimes surprising.

80% of the respondents have a two-tier structure; and 80% have an Audit Committee installed. Looking at the composition, only 44% has independent members exclusively and almost 16% has an Audit Committee consisting entirely of members from within the organization. Many of the latter are to be found in the Public Services organizations.

The average years of the existence of the Audit Committee demonstrated the fact that an Audit Committee is on the rise only recently. The minimum was 0 years and the maximum 31 with an average of a little over 6 years. Comparing these numbers with the existence of the IAF the results are even more striking. The IAF exist an average of almost 14 years. Out of the 112 that reported the number of years their IAF existed, 45 (40%) had it for 5 years or less and just 22 reported that their IAF existed for more than 20 years, one of them existed for 180 years! It is difficult if not impossible to conclude that IAF's are on the rise but 45 having an IAF for less than 5 years might point in that direction. Repeating this survey over a number of years might reveal more detail and conclusive answers.

The effects of Corporate Governance regulations coming into effect

As already elaborated one of the reasons for this research was the issue of Corporate Governance regulations coming into effect and the desire to research the effect on the IAF. A number of questions were surveyed to see the development. In this section several results are discussed. For the confidence intervals a finite population correction was applied:

Table 6-13: What has happened to the IAF during the last three years (1 = strongly disagree, 5 = strongly agree)

Question	N	Min	Max	Mean	Std. Deviation	Lower-bound	Upper-bound
24. Shrinking in size	114	1	5	2.19	1.36	2.10	2.29
25. More consultations with Supervisory Board/Audit Committee	112	1	5	3.65	1.16	3.57	3.74
26. Received less assignments from Management Board	113	1	5	1.94	.864	1.87	2.00
27. Received more assignments from Supervisory Board/Audit Committee	111	1	5	3.23	1.18	3.14	3.31
28. Cooperating less with External Auditor	112	1	4	2.10	.932	2.03	2.17
29. Received a bigger budget (10% or more)	113	1	5	3.03	1.3	2.93	3.12
30. More Internal Audit activities were outsourced	113	1	5	1.89	1.0	1.81	1.96
31. IAF has been decentralized	112	1	5	3.32	1.42	3.22	3.43

Lower- and Upperbound are at a 95% confidence interval.

It is clear that the IAF during the last 3 years has received more meetings with and assignments from both the Supervisory Board/Audit Committee and the Management Board, demonstrating an increased need for their services. This increased need is underpinned with the fact that the IAF got an increase in budget and did not – although less convincing – shrink in size. It seems that the increase in budget is more significant than the increase in size (staff). Apparently the increased need for their services led to a more efficient but better resourced (due to the increase in budget either in tools or higher qualified people) IAF.

It shows that they were cooperating more with the External Auditor as might be expected due to the developments described in Chapter 3. Also interesting is the score on the decentralization question. It shows that there must have been a trend towards centralization of the IAF. This trend was already noted in the realm of the case studies and it will be elaborated further in subsequent sections.

Also the expectations for the upcoming three years based upon the Corporate Governance regulations coming into effect were surveyed. The increase in communication between the Supervisory Board/Audit Committee is expectedly to be enhanced even further (4.22 on a scale of 1-5), as well as the number of assignments (3.95). This will increase their independence as well (1.93 when asked whether this would decrease it) as well as the quality of their services (4.02). The downside is that many Chief Audit Executives do expect that this might create more tension because he/she hast to serve more than one master (3.24). And yes, outsourcing is even less likely (3.36, when asked whether outsourcing will be increased).

The same questions were asked to Management Board and Supervisory Board/Audit Committee members and the comparison between the scores of the Chief Audit Executive and theirs is shown in Table 6-14. Again, a finite population correction has been applied.

Table 6-14: Comparing expectations of Chief Audit Executive (CAE), Management Board (MB), and Supervisory Board/Audit Committee (SB/AC) upon Corporate Governance regulations coming into effect for the next three years

Question	CAE	MB	SB/AC	Overall mean	ANOVA P-value
37. More communication between Internal Audit and Supervisory Board/Audit Committee	4.21	3.85	3.93		0.002
38. Chief Audit Executive receives assignments not only from Management Board but also Supervisory Board/Audit Committee	3.95	3.34	3.67		0.000
39. Greater distance between Internal Audit and the organization	2.36	2.53	2.90		0.039
40. Internal Audit will become less independent	1.93	1.96	1.93	1.94	0.982
41. A higher quality of Internal Audit services	4.03	3.88	3.90	3.95	0.347
42. More tension for the Chief Audit Executive (more masters need to be served)	3.22	3.13	2.93	3.14	0.436
43. Less conferencing with the External Audit	2.10	2.38	2.17	2.22	0.064
44. Internal Audit budget will be cut back (10% or more)	2.03	1.99	2.07	2.02	0.916
45. Tension between External Audit and Internal Audit will increase	2.61	2.50	2.83	2.60	0.330
46. Less outsourcing of Internal Audit activities to third parties	3.37	3.23	3.31	3.30	0.650

P-values less than 0.05 show up for questions 37, 38 and 39. The significant differences in opinion for the questions 37 and 38 are corroborated with the results of the case studies shown in Chapter 5.

As shown in Chapter 3 the IAF has begotten a more prominent role in the Corporate Governance regulations. What is more is that the Supervisory Board/Audit Committee is expected to oversee – congruent with the Tabaksblat provisions (see Chapter 3) - what the Management Board is doing with the IAF. The effect of having more contact with both the Management Board and the Supervisory Board/Audit Committee has also become clear in the case studies in Chapter 5. Questions 25 and 26 (see Table 6) also showed that there have been more consultations and more assignments by the Management Board over the previous three years. Therefore, it is no surprise that there is consensus among the Chief Audit Executives, the Management Board, and the Supervisory Board/Audit Committee that there will be more communication between them as well as assignments for the Chief Audit Executive.

Having more contacts with the Management Board as well as the Supervisory Board/Audit Committee may in itself be good news for the stature of the IAF. This also fosters greater attention to the work of the IAF by those bodies. The downside is that the IAF may be seen by the rest of the organization as 'spy' of both the Management Board and Supervisory Board/Audit Committee. The findings of the IAF were already reported to the Management Board in the past, but now they will also be visible for the Supervisory Board/Audit Committee. The Management Board is part of the organization. Although lower level management would in many instances prefer – especially negative – audit findings not to be reported to the Management Board, they know such is inevitable. Such may be viewed differently when results are reported to the Supervisory Board/Audit Committee. They are representatives of the shareholders and therefore considered to be more outsiders than insiders.

It seems that the Supervisory Board is slightly more convinced than the Management Board and the Chief Audit Executive that some alienation between the IAF and the rest of the organization may occur. Although the scores show that there is no real perceived danger of alienation although the numbers do not denote there is no danger at all. Based upon the findings of the case studies (see Chapter 5) this score is reassuring because the Chief Audit Executives in the case studies saw some danger of alienation.

The much debated issue of independence shows the highest congruence of opinion among Chief Audit Executives, Management Board, and Supervisory Board/Audit Committee members. Not only are scores congruent, there is also *'communis opinio'* that the Corporate Governance era will enhance the independence of the IAF. If the Supervisory Board/Audit Committee is becoming more and more probing and also more involved with the internal audit activities this will foster the independence. The Supervisory Board/Audit Committee is representing the 'principals' of the Management Board as the 'agents'. In the triangle between with the Chief Audit Executive this will strengthen their position. This will also be underscored by the scores on the questions 32 to 36 which will be discussed below.

There is common ground that the quality of the services of the IAF will be increased by the Corporate Governance regulations. The Chief Audit Executive is very convinced (4.03) that such will the case. This was also corroborated by the case studies of Chapter 5. The rationale behind that might be that if pressure is increased the need to deliver high quality services will be increased as well. There is more at stake and more powerful oversight is exercised, e.g. via the Supervisory Board/Audit Committee. Furthermore, regulators are becoming more probing as well, further increasing the need to deliver high quality services. Surely the question will be at what cost this quality will be increased? Will the number of hours of training and education be increased? Will there be a focus on more experienced audit staff and a subsequent increase of budgets to pay for that?

The latter consequence seems to be supported by the scores on question 44. A high consensus number is achieved (2.03) that the budget of the IAF will not be cut back with 10% or more, meaning that it is expected that the budget will be increased rather than decreased.

Although there is not much consensus around the question of the Chief Audit Executive being more subject to tension as a result of the need to serve more than one master (question 42), the trend is that the new era will indeed increase tension. Not surprisingly the Chief Audit Executive scores the highest (3.22); the Supervisory Board is less convinced that tension will increase (2.93), leaving the Management Board in the middle (3.13). This increase in tension will foremost be experienced by the Chief Audit Executive. As described in Chapter 2 he might end up in a situation best described as 'between a rock and a hard place'. The case studies in Chapter 5 already provided anecdotal evidence of this tension.

Just missing the mark of a P-value smaller than 0.05 is the score on question 43 about conferencing with the External Auditor (P-value 0.064). The scores show that there is much agreement that conferencing with the External Auditor will be more. Again, this is no surprise as it is corroborated by the case studies. Also the need for Supervisory Board/Audit Committees to exercise oversight of the services of the External Auditors as well as the IAF will enforce their need to have a coherent and comprehensive overview of audit services irrespective to who is the provider. The data shown in Table 14 (see below) will underpin this expectation. The question whether this will increase tension between External and Internal Auditor is somewhat ambiguous. Scores are well in the middle of the 1 to 5 scale with an average of 2.65.

There is also some consensus (P-value of 0.650) that outsourcing will be less (score of 3.30 on the question whether there will be less outsourcing to third parties; question 46). This is aligned with the above findings of the expectation that there will be more demand for services of the IAF, more budget, more conferencing with the main players in the governance arena (as depicted in Chapter 1 in Figure 2), and a higher quality of IAF services. The case studies already showed that outsourcing was never really considered to be a viable option. If you need it, better have it in-house seems to be the overwhelming idea.

Who should the Chief Audit Executive be responsible to?

First of all the survey questioned the perspective who the IAF/Chief Audit Executive should report to, meaning whom should he be responsible to. In Chapter 2 much was said about independence, the view of the Standards of the profession, and the responsibility for the IAF. In Chapter 3 the results of the Corporate Governance developments was described and it was shown that there had been a shift in the perspective and that the Supervisory Board/Audit Committee was increasingly required to take the helm instead of the Management Board. The results of research applying Agency Theory and Transaction Cost Economics were debated in Chapter 4. Agency Theory positions the IAF in the agent – principal perspective and auditors would be best 'in the hands of the principal'. In this respect having the Chief Audit Executive/IAF report to the Supervisory Board/Audit Committee would be favoured.

In the case studies it became clear that there were some differing views. In The Netherlands the IAF has been firmly in the hands of the Management Board and this was acknowledged by the Tabaksblat Committee (see Chapter 3). Nevertheless, it became evident that Supervisory Board/Audit Committee members were increasingly aware of the importance of the IAF and its possibilities to support them in their supervisory tasks. In Table 6-15 the results are shown whereby the question was to score the favoured position of the IAF without taking into account the actual situation within the organization. A finite population correction has been applied.

Table 6-15: Responsibility for the IAF in the eyes of the Chief Audit Executive, the Management Board, and the Supervisory Board/Audit Committee

Question	CAE	MB	SB/AC	Overall mean	ANOVA P-value
32. Chief Audit Executive should be responsible to CEO	4.04	3.80	4.07	3.95	0.355
33. Chief Audit Executive should report to the CFO	1.83	2.40	1.73		0.002
34. Chief Audit Executive should report to Supervisory Board/Audit Committee	3.70	2.76	2.87		0.000
35. Chief Audit Executive should have meetings with Supervisory Board/Audit Committee independent of Management Board	4.19	3.20	3.50		0.000
36. Hiring, firing, appraising Chief Audit Executive should be done with approval of Supervisory Board/Audit Committee	4.12	3.09	4.17		0.000

P-values less than 0.05 show up for all questions but one (32). All respondents agree that the CAE should report to the CEO and not the CFO. That is a promising conclusion since this is the position of many Corporate Governance regulations and the position of the IIA Inc. Less promising are the significant differences in opinion that the CAE should not report to the CFO. As shown in Chapter 2, the CFO was still the most common function to be responsible to in 2001 (59%). Surprisingly, the Supervisory Board/Audit Committee are most outspoken that the CAE should not report to the CFO (1.73).

The CAE should report to and have meetings with the Supervisory Board/Audit Committee independent of the Management Board; and that their hiring and firing should be done with the approval of the Supervisory Board/Audit Committee. The Management Board seems to be more reluctant to ask the approval of the Supervisory Board/Audit Committee for the hiring, firing, and appraising of the Chief Audit Executive than the Supervisory Board/Audit Committee would like them to.

Concluding the position issue it is clear that shifts take place and that the Chief Audit Executive/IAF is more and more within the hands of the CEO and the Supervisory Board/Audit Committee than used to be the case. This is a trend that is aligned with the expectation based upon the Corporate Governance regulations (Chapter 3), the developments shown in Chapter 2 as well as the expectations based upon Agency Theory predominantly (Chapter 4), and the results of the case studies (Chapter 5). Nevertheless, the issue will be on the front page of the Chief Audit Executives newspaper for the next few years and consensus is not yet reached. Some ambiguity is still going on.

Comparing the results of the expectations of the Chief Audit Executive and the historical and actual situation shows some differences. In 2001 the Chief Audit Executive was responsible to the CEO predominantly (56%) and the next in line was the CFO (35%). In almost 4% they were responsible to the Controller and just in 1.9% the Supervisory Board/Audit Committee. In 2004 numbers were already shifting.

By 2004, being responsible to the CEO went slightly up to a little more than 57% and to the CFO geared down to a little more than 28%. The Supervisory Board/Audit Committee number went up to almost 9%. For the next three years expectations are that the speed of change will increase even more.

By 2007, the CEO as responsible party is expected to go up to 61.5% and the CFO will be cut in half to close to 14%. The Supervisory Board/Audit Committee will in the expectations of the Chief Audit Executive go up from almost 9 percent to 20.5%. Surely these numbers are aligned with the expectations of the Chief Audit Executives as already shown above. It will be interesting to survey this issue again in the future to see what has happened in the meantime. But, if those expectations are to be fulfilled it is clear that a major shift is going to take place over the next few years. By then the Tabaksblat report may need to be adjusted since they position the Management Board as being the one responsible for the IAF.

Chief Audit Executives are of the opinion that they should have meetings with the Supervisory Board/Audit Committee independent of the Management Board and that their hiring, firing, and appraising should be approved by the Supervisory Board/Audit Committee. Although this may be true as an expectation it is far from common practice. In almost 55% the Chief Audit Executive currently never meets with the Supervisory Board/Audit Committee without the Management Board being present. Apparently there is a big gap between the desired and actual situation, although the expectation is that this gap will be closed.

Size of the IAF

With regard to the size the following data is gathered. Table 6-16 shows the average size of the IAF, their average budget and the total number of in-sourced full time equivalents.

Table 6-16: Size and budget in 2004

Question	N	Minimum	Maximum	Mean	Std. Deviation
48b. Staff in 2004	90	1	800	35	112
49b. Budget in 2004	72	€ 12,000	€ 80,000,000	€ 4,811,944	€ 13,870,492
50b. In-sourced fte’s 2004	83	0	43	3	6.512

Although a boxplot and a histogram were explored to provide further insight in the data, outliers caused those graphics to be less revealing. The standard deviation already points at the large differences in the population. In other words, those numbers don’t tell a lot.

A further analysis and comparison of the numbers for 2001 and 2007 versus 2004 revealed that there were no statistical significant changes. Although absolute numbers showed a slight increase over the years, maybe due to inflation, numbers were rather stable over the years.

In Table 6-17 the average expenditure per staff (including in-sourced numbers as well) in € per annum in 2004 is shown, split by industry sector.

Table 6-17: Average expenditure per staff in € in 2004

Industry	mean staff*	mean budget	average € per staff per annum
Trade, Transport, Logistics	18	2,500,818	138,934
Production, Energy, Utilities	23	1,719,923	74,779
Telecom, IT, Media & Entertainment	7	911,888	130,270
Professional Services	6	1,091,666	181,944
Financial Services	66	8,404,657	127,343
Public Services	29	2,814,423	97,049
Total population	35	4,811,944	137,484

* in-sourced numbers included

The Production, Energy, and Utilities industry has by far the lowest average, followed by the Public Services industry. Trade, Transport, and Logistics, as well as Telecom, IT, Media & Entertainment, and Financial Services are not that far of from the average of the total population. The exception to the rule is the Professional Services industry. The reason why is not investigated, although the low number of 6 staff on average may have biased the average expenditure.

How to control the IAF?

This topic is dealt with by looking at the issue of performance based incentives as well as the instruments used to control the IAF as an entity.

Performance based incentives are used as follows. In 26% of the organizations there is a performance related pay based upon the financial results of the organization. In just over 6% of the cases the performance related pay is based on non-financial results. The majority is based on up front agreed upon milestones for the Chief Audit Executive/IAF (46%). In four cases, (3%), other performance related items are taken into account. In 19% of the cases, no performance related pay is used at all, meaning that 81% of the organizations used some form of performance based pay. The 81% that uses performance based pay is in line with what to be expected based upon Agency Theory. The use of performance based pay is best developed in the Telecom, IT, Entertainment and Media industry (80%) and least developed in the Public Services (16%). For details see Table 6-18 below.

Table 6-18: Performance related incentives for the Chief Audit Executive per industry

	Industry					
Performance criteria	Trade, Transport, Logistics	Produc-tion, Energy, Utilities	Telecom, IT, E&M	Prof. Services	Financial Services	Public Services
None	6	7	2	4	11	31
Financial results	7	8	5	4	19	6
Non financial results	4	2	3	1	8	0
Internal Audit Milestones	3	2	0	0	2	0
Other	0	0	0	0	1	0
Total number using performance criteria	14	12	8	5	31	6
Percentage using performance criteria	70% (14/20)	63% (12/19)	80% (8/10)	56% (5/9)	74% (31/42)	16% (6/37)

There is one other caveat that needs to be pointed at. Poppo and Zenger (1998) tested alternative Theories of the Firm and used – besides Transaction Cost Economics – knowledge based, and measurement explanations for Make or Buy decisions and found that: "…. Managers are more likely to choose hierarchy when performance measurement is difficult". (1998, 873-874). In Chapter 4, some comments were made about performance based pay for internal auditors and the results described in Chapter 5 pointed at the difficulty to find appropriate measures to provide a sound basis for the appraisal and incentives for the Chief Audit Executive. The finding of Poppo and Zenger may provide another compelling argument to internalize an IAF. Another finding of their study was that imprecise measurement of performance constrains the incentive intensity of rewards and – in return – low-powered rewards limit performance. Again, keeping the results of the case studies and the above survey results in mind, it may be true that whilst measuring the performance of the Chief Audit Executive and the IAF is difficult and therefore constrained, this might temper the use of performance based incentives altogether.

Now let us take a look at the control of the IAF as a whole. Question 65 dealt with that and the results are:

Table 6-19: Applied control measures for the IAF

Question 65: Which of the following instruments does your organization have for Internal Audit (multiple answers were possible)?	%
Ethical code	38
Audit Charter	76
Quality system in place (file review, working methods, etc.)	74
Ad random checks by External Auditor	38
Independent review by Third Party	30
Appraisal based on measurable criteria	40
Credentials and qualifications requirements (diplomas, etc.)	73
Internal sanctions in case of poor performance	34
Compliance with Professional Standards	64
If needed complaints are filed to professional bodies (disciplinary powers)	13
Other	2

From the perspective of the Professional Standards of the IIA Inc a few remarks can be made. First, having an Ethical Code, being subject to an Independent review by a Third Party every 5 years and, therefore, having a quality system in place, and being compliant with the Professional Standards are mandatory. Scores should have been 100%, the only exception to the rule being an IAF not led by a qualified Chief Audit Executive who is not a member of the IIA the Netherlands and, thereby, of the IIA Inc as well. It may be that the IIA the Netherlands has a relatively short history thereby limiting the adherence to the Professional Standards. Nevertheless, history is not that short that scores should fail to match 100% by this far.

Others are recommended and not used to the full to say the least. All in all these findings contribute to the conclusion already stated in Chapter 2 that the issue of control of the IAF is not yet dealt with adequately enough. If the profession is called to the fore it most certainly will need to step in respect to the Standards and the way the IAF is controlled to be able to live up to the enhanced expectations and requirements.

Scope of services

The results of the survey with regard to the time spend by the IAF's is shown in Table 6-20.

Table 6-20: Time spend per audit type as a % of total

	Year		
	2001	2004	2007
Financial Audit	31	25	23
Operational Audit	34	36	35
IT/EDP Audit	15	13	14
Fraud Audit	2	2	3
Compliance Audit	8	10	12
Ethical audit/tone at the top	0	1	2
Audits of incentive and reward systems	1	2	2
Consulting	8	10	8
Other	1	1	1
Total	100	100	100

Using general MANOVA with Wilks' criterion, the P-value is 2.8% meaning that there is a statistically significant difference over the years. Based upon the P-values of single ANOVA's per audit type, the percentages of time spent on Financial Audit and Ethical Audit are the only ones that vary statistically significant over time.

A number of remarks can be made.

First of all, despite the expectations expressed in Chapter 5 that Financial Audit will be on the rise again due to developments like the Sarbanes Oxley Act, after many years of decline, is not supported by this survey. Though limited, the number is expected to decline even further in 2007. The trend so clearly visible in the last decade continues and apparently IAF's do not foresee to either wish or be able to recover that was once put in the hands of the External Auditor.

Secondly, numbers are rather stable –the exception being Financial Audit of course - over the years. There is however, a noticeable increase for Compliance Audit. This may also not really be a surprise. As shown in Chapter 3, the number of rules and regulations with regard to Corporate Governance has been increasingly rapidly over the last decade, Sarbanes Oxley being the latest fad. One might therefore expect that the IAF will also spend more time on Compliance and this might very well explain the increase from 8% in 2001 to 10% in 2004 up to 12% in 2007.

Thirdly, Agency Theory would proclaim that time would be spend on the issue of ethics and incentive and rewards systems. As discussed in previous Chapters, the IAF is not really allowed in that area. The data supports that reluctance very clearly.

In the fourth place, Financial, Operational, IT/EDP, Compliance, and Consulting make up for 95% of all audit activities of IAF's, the rest is very limited. Fraud is apparently not a big issue. Despite all the debate going on about fraud and the suggested relationship with the incentive and reward systems neither of them is on the top of the agenda of IAF's from the time spend perspective. Ethics may be important but not from the perspective of spending audit time.

Last but not least, the much debated issue of consulting is a fairly limited time consuming effort for IAF's: 8.3% for 2001; 10.6% for 2004, and 9.0% 2007 (at the 95% reliability level).

Some specific observations with regard to the Public Services industry need to be made. Financial Audit is their biggest time consuming activity but there is a vast decrease going on; numbers decline from 50% (2001) to 39% (2004) to 33% in 2007. This development is highly caused by the decision that the IAF's of the Ministries all are heading to create Operational Audit functions within their departments. Therefore the increase in Operational Audit is also explained (from 24 to 28%). Consulting is also showing a significant increase (from 6 to 12%).

The relationship with the External Auditor

The results of the questions pertaining to the relationship with the External Auditor are shown in Table 6-21.

Table 6-21: The relationship between the Internal Audit Function and the External Auditor

	Year			
Relationship with the External Audit (in %)	2001	2004	2007	P-value
64a. No relation	17	8	5	3%
64b. Sharing plans	51	69	67	2%
64c. Joint planning	23	29	44	0%
64d. External Auditor monitors Internal Audit	48	54	60	25%
64e. Internal Audit monitors External Auditor	10	18	26	1%
64f. Reports are shared between the two	62	76	78	4%
64g. Management Letter is a joint effort	20	18	24	58%
64h. Internal Audit has to work according to External Auditor requirements	21	29	29	50%
64i. Internal Audit controls budget of the External Auditor	19	24	29	37%
64j. Audits are done together	19	24	32	22%
64k. Other	3	3	3	98%

Based upon the P-values significant differences exist for the questions 64a, 64b, 64c, 64e, and 64f.

The Table shows that 'no relationship' is declining rapidly and that all other options are almost without exception on the rise. The conclusions from Chapter 2, 3, and 5 are corroborated by the findings of this survey. Sharing reports always has been a standard practice according to the numbers. Next the sharing of plans was quite common and will become increasingly so. That doesn't mean that planning is a joint effort. Although this number is expected to increase to 44% by 2007, in 2004 this was done just in 29% of the cases.

Chief Audit Executives expect that they are going to be monitored by the External Auditor more and more. On the other hand they also expect that they will in their turn monitor the External Auditor increasingly. There is however, a huge discrepancy between those two numbers. One might expect that organizations would call upon their Chief Audit Executive to help them scrutinizing the work being done by the External Auditor more than they are actually doing. After all, they are experts that have the knowledge. Agency Theory would also favour mutual monitoring. This may become more important if the expectation is true that Internal Audit is controlling the budget of the External Audit. As has already being contended in Chapter 5 it would be recommendable to refrain from having the budget being controlled by the Chief Audit Executive to prevent a possible bias due to mutual dependency.

Given the fact that External Audit focuses on Financial Audit only and the fact that from the perspective of the Scope of Services of the IAF the percentage of Financial Audit is still on the decline, it is noteworthy that the execution of joint audits is rising to 32% in 2007. Either, the External Auditor is going to be involved in other types of audits, or Internal Audit should become more heavily focused on Financial Audits, the latter is not backed up by the data though. There seems to be at least some contradiction in the numbers.

6.4 Conclusions

Summarizing this Chapter and concluding the main findings of the survey is dealt with in this section.

It was decided that a survey would be contributing to this research and the first objective of the survey was explorative. To support theory building eight hypotheses were added. The results would enable generalization - if not corroborating - of the findings of the case studies and enrich the knowledge of IAF's and point out avenues for further research.

The eight hypotheses were tested and there is only support for the relation between the size of the IAF and being an Asset Specific organization or having higher degrees of Information Asymmetry. If an organization is Asset Specific, this increases the number of staff by some 25 compared to non Asset Specific organizations; for Information Asymmetry the increase is some 13. The tests provided some support for the conclusion that Asset Specificity is an even stronger predictor for the size of the IAF.

This survey didn't provide any further support for the much debated issue of Make or Buy. The hypotheses dealing with Make or Buy were not supported. On the contrary, findings may contradict prior research like the ones of Widener and Selto (1996) and Speklé et al (2005), acknowledging that both Widener and Selto, and Speklé et al had a different set up of their survey and focussed on the Asset Specificity of the IAF itself instead of the organization.
Already in the case studies Make or Buy seemed to be driven by other attributes than Asset Specificity and Information Asymmetry per se. Further research might need to drill down into this issue. Maybe resource based research might be worthwhile (Carter and Hodgson; 2006).

Furthermore, on average the overall number for outsourced Internal Audit activities is a little less than 10% and rather stable over the years.

It became clear that many IAF shops are rather new; some 40% exists less than 5 years. To judge this on its own merit, we have to acknowledge that it may not be very likely that levels of Asset Specificity and Information Asymmetry did change that much over time in the respective organizations. Therefore, this might also underscore that the decision of Make or Buy may be based upon other factors than Asset Specificity and Information Asymmetry per se. This may indeed point to the fact that having an IAF is heavily influenced by the regulatory landscape in general and Corporate Governance in particular. Although there is no regulation – other than the New York Stock Exchange Listing Rules and those applicable for a number of Financial Services organizations – that makes an IAF mandatory, corporate scandals and subsequent regulatory drives, combined with public uproar and liability claims, may very well have been a force on its own. As shown in Chapter 3, the number of Corporate Governance initiatives during the last decade has been notable. Furthermore, in many of these publications Internal Audit has got at least some attention.

With respect to the Scope of Services no support was found to relate that in any way to Asset Specificity and Information Asymmetry. In the future, other directions are needed to get some insights and clues where to find the drivers for defining the Scope of Services of the IAF. There is at least some circumstantial evidence in this survey that there is also a relation with the Corporate Governance regulations as well. Time spend on Compliance Audit has risen from 8% in 2001 to 10% in 2004 and is expected to increase further to 12% in 2007.

To substantiate the developments due to Corporate Governance during the last three years a number of findings are relevant. Chief Audit Executives consulted more often with the Supervisory Board/Audit Committee and received more assignments of both Supervisory Board and Management Board. Outsourcing decreased and the cooperation with the External Audit was enhanced. Chief Audit Executives also received more funding and their IAF was in staff rather increased than decreased. Another clear trend was the centralization of the IAF. If we have one, let us make sure that it reports to the highest levels and thereby enhance its position and independence, seems to be the overarching idea.

Asked upon their expectations for the next three years Chief Audit Executives proclaimed that trends described above will continue to have their effect. They expect that these developments will further enhance their independence and foster the quality of their services. The counter side is that they expect more tension as they have to live up to the expectations of not only the Management Board but also the Supervisory Board/Audit Committee and thereby may have more than one boss. Those expectations are more or less shared among Chief Audit Executives, Supervisory Board/Audit Committee, and Management Board members although the Chief Audit Executive is in many cases more outspoken. The scores for Chief Audit Executives on the one hand and Management Board and Supervisory Board members on the other hand for the increase in communication between Internal Audit and the Supervisory Board/Audit Committee and receiving assignments by the Supervisory Board were statistically significant controversial. Whether there would be an increase in the distance between Internal Audit and the rest of the organization also led to some controversy.

Although all respondents agreed that Chief Audit Executives should report to the CEO; just 57% does. The statistical significant and most controversial themes were around the issues of:
- whether or not to report to the CFO (in 2004 28% does);
- whether the Chief Audit Executive should have meetings with the Supervisory Board/Audit Committee separated from the Management Board; and
- whether hiring, firing, and appraising of the Chief Audit Executive should need the involvement of the Supervisory Board/Audit Committee.

Although the Chief Audit Executives overwhelmingly (score of 4.18 on a scale from 1 to 5) plea to have separate meetings with the Supervisory Board/Audit Committee without the Management Board being present, only 54% never does.

Instruments to gain control over the IAF are an area of concern. Performance based incentives are applied reasonably widely; some 55% uses them. Agency Theory nevertheless, would call for more. Quality measures for the IAF are in need of enhancement. Disciplinary powers are exercised the least (13%) which may be a surprise for a professional community reigned by codes of conduct and such powers in place. They most certainly are one of the most deterring instruments and this may also be the reason not to apply them on a broad scale.

IAF's in many cases officially adhere to the Professional Standards in 64% of the cases; ethical codes are applied in merely 38%, and external independent reviews are in use by just 30% (although the latter has been coming into effect very recently). Highest scoring instruments are the Audit Charter (76%), a Quality System (74%), and Credentials and Qualifications (73%). It seems to be an understatement that there is some room for improvement, especially from the perspective that the Chief Audit Executives envision the quality of their IAF will be enhanced due to the Corporate Governance developments. Furthermore, a number of these instruments are mandatory by the IIA Professional Standards.

Some major shifts in the Scope of Services are to be noted. Most noteworthy is that Financial Audit is decreasing from 31% in 2001 to 23% in 2007 and Compliance Audit is increasing from 8% in 2001 to 12% in 2007. All others are fairly stable over the years. Ethical audits and Audits of Incentive and Reward systems hardly exist (2-3%). The same is true for Fraud Audit (2-3%). The expectations based upon Agency Theory not only were not met based upon the findings of the case studies; the survey again underpins the lack of those audit types. In the light of the many corporate scandals, which in its turn led to the flow of Corporate Governance reports did not affect that part of the Scope of Services of IAF's significantly. Consulting Services scores some 10% and is – like the outsourcing issue much debated in the profession - just a relative limited service offering. The number is also very stable over time, industries and countries as was already demonstrated in Chapter 2.

The relationship with External Auditor is becoming more intimate and it is fair to say that External and Internal Auditor are to be 'condemned' to one another, especially true in the realm of the Corporate Governance regulations.

This survey has several limitations that should be recognized when interpreting the evidence in this Chapter. Although the survey has been thoroughly developed and tested, there is no guarantee that some questions might be misinterpreted. Defining what the different audit types are is not that easy and there might be some mix up. Furthermore, several data, especially those pertaining to hard numbers may be best guesses since this data may not have been readily available upon filing the survey.

Furthermore, this survey aimed at organizations that do have an IAF. It intentionally did not include does that did not have an IAF, to be able to find more conclusive answers to the questions raised in this research. Nevertheless, this route does not allow to corroborate, contradict, or any else, the data with data from organizations that do not have IAF.

This research has been executed in the Netherlands, a small country in a vast global community. There may be some biases affecting the generalizability of the findings. We have found somewhat contradicting results with research done by Widener and Selto (1996) in the US. Though this might be due to the difference in territory, it also does not corroborate with research done in the Netherlands as well by Speklé, et al (2005).

Last but not least, the issue of the ‘chicken or the egg’ is relevant. What we saw as being Asset Specificity or suffering high levels of Information Asymmetry may be a consequence rather than an antecedent of having an IAF and its sourcing decision; this might in itself cause a preference for in-sourcing Internal Audit.

Chapter 7 Conclusions and Recommendations for Future Research

7.1 Introduction

I have researched the changes brought about in Internal Audit (IA) due to Corporate Governance (Corporate Governance) regulations that have been coming into effect for more than a decade. My research questions were specifically focused on IA's role, position, and scope of services. Which led to the following:

- What is the role of IA? Why does IA exist? What is its *raison d'être*, or, as some would put it, its "license to operate"?
- What are the considerations for the "make or buy" issue for IA (in-source or outsource)?
- What position can it have within the company? That is, what can its relationship be with the Management Board and Supervisory Board/Audit Committee? And in a conflict between those two, which relationship could have precedence?
- How large can it be?
- How can IA be controlled?
- What can it do? In other words, what is its scope of services?
- What is the relationship with the External Auditor?

I will start with a brief synopsis of the results of the research presented in the previous chapters. I will then discuss contextual and methodological limitations of this thesis. And will conclude with some recommendations for further research.

7.2 Summary and Conclusions

In Chapter 2 we learned that (internal) auditing goes back a long way. But theory is still in its infancy. The International Federation of Accountants (IFAC) developed a framework for understanding what auditing is. It aims at providing assurance about specific subject matter, which is based on comparing the current state of affairs with a predefined "ideal" state, called "the norm" or "criteria". This is achieved through an assurance process and carried out by an assessor (called an "auditor"). The auditor verifies data through evidence and reports his results orally or in writing.

Notable efforts to define auditing have been made by Mautz and Sharaf (1961), Flint (1988) and Wilschut (1994). Others, such as Kamp-Roelands (2002), have followed in their footsteps. Mautz and Sharaf emphasized the need for a philosophy of auditing that draws on other theories and disciplines. Otherwise, "it will not only lose stature in the eyes of the world, but it will forfeit the best method of solving its most perplexing problems." (1961,17)

On the flip side of that are audit's detractors. Critics like Power (1997) and Pentland (2000) have accused it of obscurity and questioned its validity. And those are issues that are definitely worth taking in and pondering. However, one way around a deeply troubling issue is to take shelter under that great umbrella of "general scientific research". Say that auditing is an offshoot of that. I would argue for adopting the basic principles of scientific research.

Focusing on the auditor revealed that his main characteristics are knowledge, expertise and independence. Independence is a much debated issue. Does it have value in and of itself? Or is it the resultant of other things? Like objectivity and integrity. Some say it is all about professionalism, due diligence, competence, objectivity, probity of character, integrity and other high minded words. Is that a matter of what used to be called *obscurum per obscurius* (explaining the obscure by the more obscure) and is known these days as "fog displacement"?

Some believe independence is the cornerstone of the profession. Some contend it its Achilles' heel. I myself am extremely reluctant to invoke the subject in IA domain. Why? Because internal auditors are inherently dependent on whomever they work for. Be it the Management Board or the Supervisory Board. The same could be said about the external auditor as well. But to pass judgment on that point is beyond my experiential and investigative competence. Perhaps the best compromise is to conclude that IA is dependent, but there are limits on that dependence and some excursions into the realm of independence are possible.

The bottom line is that the issue is limited to who the Chief Audit Executive reports to. Traditionally, at least in the recent past, IA has been an instrument in the hands of the Management Board. But due to changes in the Corporate Governance environment, the Supervisory Board/Audit Committee has been getting more involved in its activities. The two-tier environment increases the risks of IA ending up even less independent than it already is. That is, in being dependent on and having to serve two masters: the Management Board and the Supervisory Board/Audit Committee.

Others try to solve the independence issue by outsourcing IA. Having it done by an "outsider", who, it is believed, is more independent. But this is also not the answer. Because all of most of IA's benefits - namely, being close to the Management Board and/or Supervisory Board/Audit Committee, being seen as an insider, "one of us", and an intimate working knowledge of the organization, its culture, people and ways of doing business - then go out the window. Cost is another obstacle in the way of a knee jerk "buy" solution.

While there is no way of telling whether the corporate scandals of recent years were any worse than what has always happened in history, there are strong indications that more noise was made about them. At least in the media. In any case, that has led to flurries and more flurries of reports, studies, committees, commissions and new Corporate Governance recommendations and regulations. Caught in the updraft of those initiatives, IA has become almost mandatory for the first time in its history. In the US, IA - whether in-house or outsourced - is mandatory for New York Stock Exchange listed companies and those falling under the Federal Deposit and Insurance Companies Act.

Chapter 3 outlined some of the major national and international Corporate Governance regulations that have been coming into effect for more than a decade, which have impacted IA and contributed to its increased status and prestige. According to current regulations and proposals in the one-tier environment, Audit Committees have been assigned more responsibilities regarding IA. Which includes helping to supervise, directly or indirectly, its agenda and activities.

The Combined Code in the UK seemed to go even farther than US legislation. There the Audit Committee has total responsibility for IA. But the catch is that IA is not yet a mandatory function. The European Union (EU) lagged behind. The Winter Group made a concerted effort, but hardly even mentioned the existence of IA, let alone detail significant provisions about it. Because of a potpourri of national judicial systems Winter decided, probably wisely, against single Corporate Governance standards for the entire EU.

The Netherlands was, until recently, one of the least developed countries with respect to Corporate Governance regulation. But then along came Tabaksblat and there was an almost overnight overhaul. Nevertheless, it fosters a blatantly ambiguous perspective about the Audit Committee's relationship with IA. On the one hand, it should maintain a decent distance. Indirectly supervise its activities through its relationship with the Management Board. On the other, it should take some direct responsibility by having meetings with the Chief Audit Executive, noticing its findings and discussing its work plan.

But the global trend is obvious. Increasingly, the Audit Committee is becoming an important player for IA. With that given one would expect that the serving two masters issue - particularly glaring in The Netherlands' two-tier environment - would at least be recognized and acknowledged, if not necessarily immediately confronted and resolved. What then? Even if it is resolved, will that solve all problems, especially around the issue of independence? I wouldn't put any money on it. But it will at least eliminate murky distinctions, such as between administrative and functional reporting lines, which in a system that brags about transparency conceal more than they reveal.

Corporate Governance codes that insist on companies reporting on the soundness of their internal control systems - also known as Management Control System) - have affected and will continue to affect IA's scope of services.

If one's goal is to raise IA's stature and importance, the good news is it is very much in demand. With that new found success, however, has come hazards, moral and otherwise. One is the possibility of putting too many - and not always compatible - services in the picnic basket. Raising expectations among members of Management Board and Supervisory Boards beyond the point of possible delivery. Another is in a profession still not well grounded in theory - again, what and why it is, and what it should, and should not be doing - getting kidnapped and being held hostage by the whims of whoever at any given moment owns it.

In Chapter 4 I discovered that theories and research specifically devoted to IA is extremely limited. But I latched on to and focused on two theories that seemed to provide at least some of the desired grounding for IA: Agency Theory and Transaction Cost Economics. Agency Theory is essentially about getting the marginal conditions right, resource allocation and employment, and providing insight into the continuous process of aligning the goals and objectives of principals and agents through incentives and rewards. Transaction Cost Economics focuses on governance structures. Which governance structure is best suited to deal with economizing on transaction costs and adapting to changing market conditions?

Agency Theory's Information Asymmetry – though difficult to measure and only through proxies that are as yet not well tested - is the dominant factor used to explain the rationale of auditing in general. It is also valid for explaining IA's raison d'être. The higher the level of Information Asymmetry the sooner auditing in general and IA in particular is deemed necessary. Agency Theory also stresses the importance of the independence issue. In order to gain credibility as a reliable witness in the eyes of the principal - that is, the shareholders and their other agents (Supervisory Board/Audit Committee) - IA has to be perceived as being both independent and objective. In this context, we obviously have to keep in mind the severe constraints gone into above.

Deeply rooted in the belief that incentives and remuneration are needed to get the best out of agents, Agency Theory also proclaims that IA's scope of services should include not only the Management Boards activities, but also its incentives and rewards schemes. It also has something to bring to the table when the issue of monitoring IA is on the agenda. These include:

- A code of conduct
- Internal quality control measures
- Performance-based remuneration
- Ad random checks by external auditor on IA's functioning
- Hiring qualified auditors
- Credible disciplinary rules
- Adherence to the Professional Standards of the IIA Inc.

Transaction Cost Economics main applicability is about "make or buy". According to it, the higher the Asset Specificity, the better the argument is for "make". It also provides evidence that governance structures, adaptation (change) processes, and an organization's Management Control System should be subjected to auditing. Therefore, they should be included in IA's scope of services.

Both Agency Theory and Transaction Cost Economics have relevance and significant added value for IA. At the end of Chapter 4 I summarized some tentative conclusions drawn from studying them. I concluded that they weren't enough to get me to where I wanted to go. Therefore, I decided to beef them up with four case studies (described in detail in Chapter 5). Those showed that a number of those theories' tentative conclusions were supported in the Dutch environment. But some weren't.

Transaction Cost Economics Asset Specificity was shown to have merit to explain IA's rationale, size and the "make" choice. All case studies showed high Asset Specificity scores. Especially in such factors as the highly specific knowledge needed to be able to conduct audits - a deep, day to day understanding of the culture, people, complexity of the organization and business, and "how we do things around here - were factors referred to many times to internalize IA. In that respect the arguments not inconsistent with IA's major benefit (according to Williamson): it is "one of us".

Agency Theory’s Information Asymmetry wasn't supported. In fact, most of those interviewed hardly seemed to be aware of it as an issue. At least as far as they and their companies were concerned. Caplan and Kirschenheiter's (2000) research (see Chapter 4) - based on Agency Theory - was flatly contradicted. According to them, "make or buy" decisions are, or should be, based on conditions and the proverbial wisdom. Namely, IA is cheaper but external audit is better. When potential risks high, outsourcing IA will happen sooner.

All interviewees were convinced that IA is needed to provide assurance. They were so convinced of this being IA's task that none even considered expanding the mandate of the external auditor. This might have been - and, in fact, probably was - due to their frame of reference. IA was part of their woodwork, and the idea of not having it probably didn't even crop up.

Regarding IA's position there was a rather clear cut conclusion that it should remain in the hands of the Management Board. Although Agency Theory recommends that it report as close as possible to the principal - in this case, the Supervisory Board/Audit Committee - those members saw things rather differently. They are more than a little reluctant to take over the helm. Nevertheless, Corporate Governance regulations urge them to exercise oversight in order to enhance IA's independence. They acknowledged that having the Chief Audit Executive report to them accomplish that.

However, while all companies had at least a protocol enabling the Chief Audit Executive to call on the Audit Committee when it was deemed necessary - deemed necessary by who, under what specific circumstances and with what consequences? - many Chief Audit Executives felt some tension as a result of having to serve both the Management Board and the Supervisory Board/Audit Committee. In the eyes of both Management Board and Supervisory Board/Audit Committee members, however, this tension however, is something that any "well groomed" Chief Audit Executive should be able to master. I would be hard pressed to find a better example of buck passing.

Using either Agency Theory or Transaction Cost Economics arguments, it proved difficult to find a clear relationship between the size of the company and IA's absolute size. Although size definitely contributes to the attractiveness of in-sourcing, there was no way of determining how large (or small) it should be.

Regarding ways of dealing with IA's agency problem, almost all recommendations stemming from theory were present in all four companies. Codes of conduct, internal quality control measures, and requirements about qualifications and proficiency of auditors. Professional standards were applied and adhered to. IA was monitored through ad random checks by the external auditor. However, there were a few that were not fully supported. The most obvious being the performance based remuneration of the Chief Audit Executive. The main reason was the perceived negative impact on IA's - here it comes again - "independence". But as we noticed in Chapter 5, getting that right might just be a matter of selecting the proper metrics.

The other instrument not being applied was credible disciplinary powers. Although those exist inside the organization, external ones applied by the profession are not "credible". One cannot hold individual Chief Audit Executives accountable for this glaring gap. That is a matter for the profession to tackle together. One of the major obstacles to anyone walking down that road in the near future is that there needs to be someone on the inside telling them that there might at least be probable cause to investigate. That can happen only if companies shed some of their traditional reluctance to blow the whistle on themselves.

The following conclusions were drawn about IA's scope of services. Transaction Cost Economics prediction - that it is best to expand beyond the plain vanilla financial audit - seems to be borne out by all but one of the case studies. Due to the demands of boards - or at least someone telling them they should demand it - other types of audits were included. Such as fraud, ethics, risk management, quality, change management, compliance, and quality initiatives, consulting, and environmental auditing.

There are two areas that both theories say should be included in IA's scope of services, because they are considered crucial for the proper functioning of an organization's Management Control System (see Chapter 4). They are the tone-at-the-top (functioning of the Management Board) and its incentives and rewards systems. But they are not even on the wish list of many interviewed (especially Management Board members), let alone at the top of it. They believe that internal auditors lack both the knowledge and accepted standards that behaviour should be measured against. Supervisory Board/Audit Committee members, by contrast, are more than willing to hear from the Chief Audit Executive if "undesirable behaviour" and breaches against code of conducts are observed. As for IA reviewing the Management Board's incentives and rewards systems, they were decidedly against the very idea.

The case studies showed very mixed results for the prediction that if highly specialized knowledge of the organization was needed to do a proper audit IA would be involved in the external audit. The scores for IA being used to reduce external audit costs were rather indifferent.

Clear support was provided for IA to be a tool supporting and fostering management control and the need to coordinate with the external auditor to be cost efficient. The need for this coordination will be furthered even more due to Corporate Governance developments. This will need attention because all but one of the case studies showed that during the last decade a clear cut had been made between IA focusing on audits other than financial and the external auditor whose sole task was the financial audit.

The 8 hypotheses that were tested via the survey (Chapter 6) showed that that there is support for the relation between IA's size and being an Asset Specific organization or having higher degrees of Information Asymmetry.

It became clear that 40% of the IA's included in the survey have existed for less than 5 years. Since generally speaking organizations' characteristics do not change much over such short periods of time, it is highly unlikely that Asset Specificity or Information Asymmetry, or a combination of the both, were the drivers for these changes. The more likely explanatory factors are corporate scandals, public uproar, a rise in liability claims as a result of shareholders activism and Corporate Governance initiatives.

The much debated issue of make or buy seems, again, to be much ado about nothing. The hypotheses dealing with that topic were not supported. On the contrary, my findings contradict prior research. For example, Widener and Selto (1996) and Speklé et al (2005). On average the overall number of outsourced IA activities is a little less than 10%. Combined with the findings of my case studies - outsourcing being never really considered as a viable option - it may mean that where IA exists there is a tendency to exploit IA to the max. Perhaps the latter also concurs with the finding that neither Asset Specificity nor Information Asymmetry provided any clues as to the direction of the scope of services.

The survey was consonant with a number of findings of the case studies. The most relevant alignments were:

- ❖ Chief Audit Executives meet more often with and receive assignments from both the Supervisory Board/Audit Committee and Management Board.
- ❖ The cooperation and relationship with the external auditor was enhanced.

- ❖ Chief Audit Executives had larger budgets and their IA's were sooner increased than decreased.
- ❖ IA's were increasingly centralized, which enhanced its position and independence.
- ❖ Chief Audit Executives prefer to report to the CEO but would also like to have the Supervisory Board/Audit Committee involved in their hiring, firing and appraising. The Supervisory Board/Audit Committee concurs. But the Management Board is more reluctant.
- ❖ Chief Audit Executives note that they feel more tension when having to serve multiple bosses. But they believe this will eventually improve the quality of their services. This, however, is not as straightforward as it sounds. Because in order to realize those improvements a number of quality controls are needed. Predominantly, adherence to the Professional Standards of the IIA Inc.

Some major shifts in the scope of services were noted. Financial audit decreased from 31% (of time spend) in 2001 to 23% in 2007. Compliance audit increased from 8% to 12% over the same period. All others were fairly stable.

Agency Theory focuses heavily on incentives and rewards to align the interest of principals and agents. Corporate Governance is geared towards enforcing necessary checks and balances to prevent what is called "dysfunctional behaviour". Tone-at-the-top and integrity are often promoted as the foundation of any control system. Thus it is all the more surprising that ethical audits and audits of incentive and reward systems are all but non-existent (2-3%). The same is true for fraud audit (2-3%). The latter might suggest that fraud is a rare phenomenon. Or, if it occurs, organizations prefer someone other than IA to investigate the matter. Given the complexities and entanglements of working in the same offices - and, so to speak, sleeping in the same beds - there is no way of telling in advance who is, and who isn't involved in any particular case of fraud, and how wide and deep it goes.

As already noticed in the case study companies, Supervisory Board/Audit Committee members want to hear from IA if there are any observed breaches of codes of conduct. But this is not yet in any Audit Charter. This reluctance was even more compelling at Management Board level. Thus one could conclude without any fear of contradiction that tone-at-the-top audits and audits of incentive and reward systems remain no-go areas for IA. As those Benedictine *circatores* (see Chapter 2) reported on the activities of fellow monks, but not those who had assigned them those tasks.

Like the make or buy issue consulting services is much debated in the profession. But it also seems to be a tempest in a teapot. Scoring just 10% of time spend - stable over time and in various industries and countries - it remains a marginal service.

Theorizing about IA is very much in its infancy.
Auditing has been around for thousands of years. But the internal branch achieved professional status only after the establishment of the IIA Inc. in 1941. A lot remains to be done to get an even moderately firm footing in the areas of generalizable insights and overview. And in order to achieve that much vigorous and rigorous research is needed. One of my first ideas for this research was concentrating on IA's added value. But I soon realized that would be a slippery slope and got off that mountain.

Nevertheless, "what is IA's added value?" remains one of the FAQ's of board members. It may have been one of the drivers that led the profession in the 1990's to favour operational above financial auditing, promote consulting services, and, eventually, to redefine the term "internal auditing" in 1999. Adding value and consulting were prominent in this revisionist definition. In 2002, the IIA Inc. presented a research report, *Adding Value: Seven Roads to Success*. The first page of the executive summary has the following quote:

If there is no universal answer to what adds most value, then the way to answer that question for yourself seems obvious: "Ask your stakeholders!" (2002c, xiii)

The report went on to acknowledge that this is only part of the answer. Stakeholders often have no idea what can be expected of specialists like internal auditors. "Its up to us to raise their expectations by telling them – or better, showing them – how much value we can add." That sounds good on paper. It will sound even better in practice. But in order to make it happen - to walk the walk as well as talking the talk - something more is called for. Namely, encouraging and supporting schools, and increasing the number of academically trained professionals, PhD's, and rigorous and convincing scientific research.

As it is, however, theory around IA is lagging behind that around external audit. It may be due to lower numbers of internal auditors, lower visibility, or even the mistaken belief that IA is an offshoot of external audit. Whatever. The important thing is show not tell. And up until now IA has not shown itself particularly helpful in detecting and preventing corporate scams.

Agency Theory and Transaction Cost Economics are two theories I applied in this research, which resulted in partial answers to a few pressing questions. Fortunately, there might be other theories that could be applicable to provide us with more telling answers that will convince more people to make bigger and better use of a new and continually improving IA (see below).

IA has gained from the Corporate Governance drive of the recent past. But most shakers and movers still haven't caught on to the idea that reward and incentive systems are the most important instruments to align the interests of principals and agents.
The case studies and the survey provided enough evidence of those gains. Nevertheless, while Corporate Governance codes are an offshoot of Agency Theory - and, therefore, all about aligning the interests of principals and agents through reward and incentive schemes - this area is not in internal audit charters. Even worse, it is not even on the agenda! Worst of all, that exclusion is deliberate, not accidental. Although Supervisory Board/Audit Committee members want to have breaches of corporate codes of conduct reported, they steadfastly refuse to endorse having it included it in the ground rules of the game. Jensen and Murphy (2004, 98) concluded delicately:

While our ability to characterize the phenomenon underlying recent problems in executive remuneration is not perfect, we are confident that the causes are systemic. The creation of a new regime in compensation practice will entail considerable thought. Otherwise, one risks re-creating the type of systems failure we have witnessed unfold in many major companies over the last few years.

While I was writing these lines another scandal rocked the media. A lot more will undoubtedly follow before you read them. In my case, the would you believe it was the backdating of stock options. In the July 17, 2006 edition of *The New York Times* more than 2,000 companies were reported to have used backdated stock options. Further analysis revealed that about 30% of all listed companies manipulated stock options. Needless to say, to the benefit of their board members - agents - and detriment of shareholders - principals.

While it is pitching too high to contend that IA in its current manifestation will prevent all or any of that, including a review of Management Board reward and incentive schemes in its scope of services isn't. Backdating stock options shouldn't be too hard to assess. Should it?

Applying Agency Theory to IA would call for using improved performance measurement, incentives schemes for Chief Audit Executive, and applying quality measures the profession already has on the books. According to Burns et al (1994) IA became a profession in 1978 when it adopted the Professional Standards. The least it can do is apply and adhere to those Standards.

Performance measurements and the subsequent rewarding of auditors are sticky wickets. Because coming up with the right metrics that truly capture what internal auditors do, and how well, are subjective and often multi interpretable (see Chapter 2 for a more in depth discussion). Nevertheless, the difficulties must be faced and overcome. Because it is extremely important to be able to assess and guarantee auditor quality. Using the infamous definition of former US Attorney General Edwin Meese III about pornography - "I know it when I see it." - isn't good enough. One good source to look for solutions could be Agency Theory itself.

Make or Buy of IA is not determined by either Asset Specificity or Information Asymmetry nor does it determine the broadness of its Scope of Services.

While make or buy for IA has been researched often I located only two studies that did so using Transaction Cost Economics: Widener and Selto (1996), Van Elten (2005), and Speklé et al (2006). They showed that outsourcing was related to Asset Specificity. Using Widener and Selto as a starting point, Van Elten and Speklé et al showed that their results were valid in the Dutch environment. But my survey tells another tale. As demonstrated in Chapter 6, research using Transaction Cost Economics is not undisputed, and is not yet as promising as was assumed and claimed by Williamson.

It is my contention that if you measure Asset Specificity of Internal Audit activities that this will surely lead to high scores on Asset Specificity due to the inherent Asset Specific nature of these activities. They require specialized knowledge and skills, the use of proprietary information and, therefore, are Asset Specific. Therefore, measuring Asset Specificity should be done at the level of the organization they are part of. Then the question is why some companies have IA while others do not? And what is the rationale for those that have it? Is it due to being an Asset Specific organization? What then drives the issue of how many staff are needed and how it is going to be organized and developed? Is the company going to rely mainly on external resources? Or is it going to build its own staff? Widener and Selto (1996), Van Elten (2005), and Speklé et al (2006) showed that make or buy of IA is driven by Asset Specificity. But even though I started off expecting - and even hoping that their research would be substantiated - I am not convinced yet .

One significant difference between our surveys was their sample population included companies that did not have IA and mine didn't. This enabled a comparison between those two populations. But they did not measure Asset Specificity on the level of the organization and could therefore not distinguish whether the presence of IA was based upon that. In my survey differences between organizations that did outsource and those that did not were still very significant. Some outsourced very little of their IA services and others outsourced almost all of them. Even with those differences taken into account, however, it was clear that neither Asset Specificity nor Information Asymmetry were related to make or buy, but only to the degree of outsourcing. I also looked at significant differences in organization size and outsourcing. But that did not provide any conclusive answers either. The results call for finding other avenues for research. One of them might be Resource Based View Theory, also known as Resource Based Theory (see more below in Further Research section).

The broadness of IA's scope of services was not related to either Asset Specificity or Information Asymmetry. Looking at the data provided by the survey, the scope of services didn't show many significant changes. Financial audit has been gradually decreasing over the years and operational auditing has been on the rise during the last decade. But that condition has been rather stable since 2001 (as were all the others). The only exception was the compliance audit, which went up from 8% in 2001 to 10% in 2004 and is expected to increase further to 12% in 2007. The most likely candidate to explain that trend is the changing regulatory landscape. On this side of "the pond" we tend to favour the "principle based" approach. On the other, the "rule based". But since the dominance of US regulations are being felt more strongly everywhere[88], pretty soon it's not going to make much difference which side of the pond you're on. Thus compliance auditing is bound to increase even more.

During the case studies it became apparent that IA's scope of services is mostly a matter of the Management Board's choice (in conjunction with the Chief Audit Executive and, ultimately, the Supervisory Board/Audit Committee). Maybe part of the rise of operational audit at the cost of financial - the operational audit "frenzy", so to speak - was more due to market push than pull. Internal auditors beating the value added drum for all they were worth and being both persistent and persuasive about it. The whole subject is well worth pursuing in future research. The framework provided by Matthyssens et al (1998) (see Chapter 2) would probably be a good *point de départ*.

In any case, further research is definitely needed to make rational decisions about IA's scope of services instead of just going with the mood of the moment.

Both Asset Specificity and Information Asymmetry drive IA size, but Asset Specificity is more compelling.

The most compelling outcome of my research is that both Asset Specificity and Information Asymmetry are predictive factors for IA's size. Previously, only rules of thumb were available. They depended, of course, on very specific thumbs. In this case, the IIA Inc. and its research from 1976. They found that in very labor intensive production companies the norm was 1 auditor per 2,000 employees (audit costs as .1% of total revenue. In production oriented organizations, the standard was 1 auditor per 1,000 employees. In financial services organizations the ratio was 2 auditors per 1,000 employees.

Those numbers have withstood the tests of time until today. I myself have used them extensively in the past during discussions and presentations. But now we can use Asset Specificity and Information Asymmetry to get a more precise grip on the sizing issue. The difference between an Asset Specific and a non-Asset Specific organization accounts for an increase of 25 audit staff FTE. A high degree of Information Asymmetry accounts for an increase of 13 audit staff FTE. But those numbers do not permit simple permutations. A

[88] As mentioned by professor Arnoud Boot in his column in the Dutch journal ESB, October 7, 2005.

highly Asset Specific small organization will most likely not have an IA consisting of 25 employees. Further research is needed to refine the calculation and perhaps somewhere along the line some kind of a usable formula will emerge.

The number of people breathing down the necks of all board members - Management and Supervisory - might influence the make or buy issue and IA size. The more outside supervisors and regulators the sooner make will be the right choice and the larger IA will be. Because no one wants to be caught with their pants down. But more research is needed on this hypothesis.

What is also new is that while Agency Theory has always been considered as the most important rationale for the existence of any audit instrument, Transaction Cost Economics has more predictive power to determine IA's size. Which is contrary to my belief at the beginning. Namely, that Agency Theory was the more likely to supply clues.

7.3 Management Implications

As I said in the Introduction (see Chapter 1) I am a man astride two worlds: business and academic. Having pushed the scientific aspect throughout this thesis, I would now like to point at some implications for the business world. In this context I simultaneously address myself to all participants depicted in Figure 1 (Chapter 1): Chief Audit Executives, members of Management Board and Supervisory Board/Audit Committee, regulators and supervisors.

First, take a close look at the IA Charter and make sure it includes everything it needs to. Next, ensure that IA is of the highest quality. I would like to draw your attention to the following items:

- In order to enhance "independence" the Chief Audit Executive should report to the CEO and have access to the Supervisory Board;
- However, in order to prevent any misunderstandings and expectations gaps, the Chief Audit Executive should be encouraged to discuss the limits of that "independence";
- The conditions should be as transparent as possible to allow proper assessment of the necessities and difficulties that lay ahead, especially the tricky prospect of serving multiple bosses and the ensuing tension; also
- Regulatory and supervisory bodies, such as Central Banks or Securities and Exchange Commissions and their colleagues, are kindly requested to refrain from imposing too high expectations on IA and trying to make the Chief Audit Executive like the external auditor only different. He isn't and never will be. He is part of the organization and should be treated as he is - constrained by the rules of his position - not as you would like him to be. Do not expect him to send you draft reports. In any case, that won't solve your need to know about possible unethical behaviour;
- Because the Chief Audit Executive will often find himself in a hot spot he will need some slack, room for maneuvering. This should improve his diligence and effectiveness and be beneficial not only to his organization, but also the environment it operates in;
- Chief Audit Executives should realize that they are an essential part of the Corporate Governance system and do their utmost to be professionals as is set forth in the IIA Inc. Professional. If they don't, they will fail to measure up to their duties and be

subject to scrutiny and punishment. This will tarnish not only their ideals, IA and staff, but also the company and profession;

- Management Boards will reap the fruits of new and improving IA's. Information gaps will be closed. There will be warnings of dangers ahead and recommendations about changes that are needed;
- Questions? How many IA staff should I have? What should they be doing? To paraphrase the IIA Inc. quote above, "Ask your Chief Audit Executive." Efficiency issues. Your IA might be able to do more more efficiently. Therefore, keep the pressure on and have it scrutinized every now and then by external assessors that know what to look for. Make minor changes now instead of major overhauls later. That will be a waste of money, energy, and human talent;
- Management Boards will be better off playing by the same rules everyone else is subject to instead of pleading for special treatment. Therefore, its members should also subject to tone-at-the-top auditing. Their reward and incentives schemes should be transparent. Why shouldn't they be? ;
- Supervisory Board/Audit Committee members should honor their commitments and use IA to do. Thus they too should push to have the kind of audits just mentioned included in the Audit Charter. Even if Management Board members find that inconvenient. Because at the end of the day they are the last resort for detecting and preventing corporate scams.

7.4 Limitations

Contextual limitations

Any research - mine included - has more limitations than its author or authors would readily admit at the beginning. Conceding them at the end isn't much fun either. From a contextual point of view, the main limitation of my research is its being entirely based in the Dutch domain (case studies and survey). Although one could argue that two of the four case studies were multinationals with a truly global reach, their home market remains The Netherlands. In my survey I also included numerous internationally oriented multinationals. Nevertheless, there could be probable cause to doubt whether all or any of the results and conclusions are generalizable to the global IA community. That external validity question is worth further research.

Another possible drawback is its almost exclusively two-tier organization orientation. As shown, 80% of the companies in The Netherlands have such a structure. Would the results have been any different in a one-tier environment? I don't think so for four major reasons. One, much of the data, especially that resulting from studies carried out by the IIA Inc. - which does have a global reach - show similar results. Two, global perspectives make the rounds rather rapidly in IA circles. Through national professional organizations - linked to international ones - and international conferences. These perspectives permeate the boardrooms of listed and unlisted companies, as well hospitals, universities, vocational schools, the public sector and municipalities.

Three, Corporate Governance developments show a tendency toward convergence (see Chapter 3). Tabaksblat draws heavily from Anglo-Saxon predecessors. In The Netherlands there are already some "well founded rumors" about how the dominant two-tier structure will develop into a one-and-half-tier one. Tabaksblat opened up the discussion about the *structuurvennootschap*. Within a '*structuurvennootschap'* the Supervisory Board – next to the Management Board and thus creating a two tier structure - is appointed by the shareholders and has the authority to supervise the Management Board on their behalf. Clearly, this hybrid will contain more one-tier elements than the strictly two-tier one. In the past Audit Committees were only mandatory within the one tier system. They were not included in the one tier system. Nowadays, Audit Committees are mandatory for listed companies. They are still not mandatory for non listed organizations. But, today more than 80% of the surveyed organizations – including the non listed organizations - have established them.

Four, previous research stemming from predominantly one-tier environments - referred to extensively in this thesis - is not inconsistent with my findings. Nevertheless, this is worth further research.

As already noted, I focused on organizations that have IA, not those that didn't.

Methodological limitations

From a methodological perspective a number of limitations need to be made explicit. One is the proxies I used to calculate the level of intra-organizational Information Asymmetry. The external Information Asymmetry proxies are found in prior research and have been adequately tested. Little or nothing was found in the literature about Information Asymmetry from the perspective of top level management vis-à-vis the rest of the organization. Requests sent by email to top researchers in this field netted no other useful feedback. Therefore, I developed my own proxies. Those proxies are described in Chapter 4 and applied in the survey. Further research should be aimed at substantiating whether they are indeed a valid starting point for further research.

With regard to the survey a few (minor) limitations should also be mentioned. First, the point of entry in all cases was the Chief Audit Executive. He was asked to fill in the questionnaire. Although he most certainly is able to have the quantitative data available pertaining to the size of the organization, etc, he might lack the ability to correctly assess the questions geared towards Information Asymmetry and Asset Specificity. Since no questions were asked as to the number of years of experience they had in the organization, it is possible that a number of them lacked the insight and experience to judge those questions correctly. Although the questionnaire was sufficiently tested and the questions themselves may have been interpreted correctly, providing answers might still have been difficult.

One solution to that problem would have been to query other company officials to enable cross testing. I deliberately decided not to do that for several reasons. Given the difficulty in coming up with sufficient addresses of those other company officials, this would have led to an extension of my research that outweighed the advantages of this extra data. Pain without gain. That assumption stems from my experience with the case studies, where I used a preliminary version of the survey. Scores there about Information Asymmetry and Asset Specificity were highly similar across the board. But due to the limited number of respondents, this is not a statement that can be backed up in any quantitative sense.

Second, the Chief Audit Executive being the point of entry to Management Board and Supervisory Board/Audit Committee members might have created some bias. If the Chief Audit Executive did not have a good working relationship with them, he might have withheld the survey. If he submitted it to them and was the intermediary on its way back to me, a further bias might have occurred. Taking that into account might have tainted their answers. In other words, they might have given significantly different response if it had been a more direct, *entre nous* communication. However, the risks of that prejudice are minimal. Board members are high ranked officers - superior to each and every Chief Audit Executive - and are not known to be shy about expressing clear opinions.

The reliability of survey data is always an issue. Did Chief Audit Executives and board members take the time needed to complete it? Or did they just jot down some off the cuff answers? Did the respondents themselves complete the survey or did they delegate it to subordinates? Would that make a difference? Probably not.

Other caveats are Chief Audit Executives, or their assistants, might have used estimates instead of set in stone statistics. Questions might have been misinterpreted. I did not send a list of definitions or examples of various audit forms because of my belief that this is common knowledge throughout the profession. But I could be wrong and some distortion could have occurred.

7.5 Future Research: Three Possible Routes

I will present three possible routes for future research:

1. Exploit Resource Based View Theory for the Make or Buy issue

Resource Based View Theory examines companies as a collection of capabilities and asks decision makers to find the best fit between that and the markets in which they operate. Put simply - and perhaps simplistically - it says, first look at what you have and then decide what you can and should do with it. It is normally used in the area of setting business strategy. But some researchers - notably Poppo and Zenger (1998) and Carter and Hodgson (2006) - have linked it to the make or buy issue. Poppo and Zenger (1998, 873-874) noted that managers are more likely to choose hierarchy (that is, in-sourcing) when performance measurement is difficult. Another remark of theirs is quoted at length because I believe it's a story worth telling.

Hierarchies are largely unstoppable engines of co-specialization yielding increasingly firm-specific language and routines. To the extent that co-specialization generates language and routines that prevent the acquisition of new knowledge sources, then internalizing activities can destroy value for the firm.… When valuable knowledge can be generated by the formation of firm-specific language and routines, hierarchy is preferred. When firm-specific routines and language generate impediments to the creation of valuable knowledge, markets are preferred.… Groups of individuals governed by markets are more likely to directly benefit from the formation of new knowledge.

This will sound familiar to those acquainted with the framework of Matthyssens et al (1998, see Chapter 2) and may explain – at least to some extent – why IA has been expanding its services so rapidly. That opened my eyes to the possibility that internalizing IA could, and possibly does, prevent the acquisition of new and valuable knowledge and actually subtract value.

> When this project officially began in February 2003, I was heartened, though not surprised, to find that Paul O'Neill [Secretary of the Treasury] had a striking view of

> the value of secrecy – *that it had almost no value*. We both happened to have read a 1998 book by Daniel Patrick Moynihan, a friend and mentor to O'Neill, who wrote that twenty years on the Senate Select Committee on Intelligence had taught him a single, sterling lesson: The threat to our national security is not from secrets revealed, it's from bad analysis. O'Neill, with his affinity for assessing how process leads to outcome, often cited the separation of information into silos – guarded as core assets by self-interested players – as one of the great obstacles to managing the huge, unwieldy American government. It has created an acute need for particularly skillful integrators – those who can move freely among silos, pick and choose, and form connections to create a fabric of shared purpose. (Ron Suskind, *The Price of Loyalt*y, vii)

It reminded me of multiple Management Board members feeling that IA had fallen behind and no longer lived up to their expectations. And an overhaul was needed.[89] Could there be an inherent "empire building" danger in internalizing a specialized function? Could (partial) outsourcing be a palliative for that risk? Another quote from Poppo and Zenger (1998, 873).

> Imprecise measurement constrains the incentive intensity of rewards and low-powered rewards limit performance.

Even if Resource Based View theory can't conclusively solve the make or buy issue, it will certainly give the discussions about it a kick in the right direction. As Carter and Hodgson (2006, 473) concluded: "Crucially, however, it is possible to reinterpret the empirical results (*of Transaction Cost Economics*). In particular, measures of human Asset Specificity fit readily into both a Transaction Cost Economics and a competence[90] approach."

2. Compare Companies that have IA with those that don't

I did my best to come up with a complete list of organizations in The Netherlands with IA, and counted about 230 candidates. Of the 144 that responded, 16 said they did not have IA. If this percentage was representative of the total, that would mean that about 26 did not have IA. This would leave a total of 204 with. While this figure is probably not 100% accurate it is more than close enough. In Chapter 6 I referred to about 1700 companies that have revenues exceeding € 100 million. That total needs to be lowered, because a number were merely holding companies, subsidiaries of Dutch or foreign listed companies, or special purpose vehicles of parent companies. But the net total needs to be increased by other means. Namely, adding other entities - such as public organizations - that would be ideal candidates to have IA (either now or in the future). The bottom line is that the number of organizations in The Netherlands that do or might fit into the IA profile might be about 2,000.

One question emerging from that research is: "Don't those need to have some kind of internal auditing done?" If the answer is yes, the next obvious question has to be: "Who does it?" Do they have some other functions inside the organization - such as quality controllers - to meet their needs? Do they have comptrollers to fill the gap? Have they expanded the mandate of the external auditor?

If the answer is no, the next question becomes even more provocative. Why not? Are they managed differently? Do their Mangement Control Systems have a totally different set up? Is

[89] Remember the discussion (mentioned in Chapter 6) between the CEO and CFO and a team of consultants about the overhaul of their IA.
[90] Another term for Resource Based View theory.

the level of "trust" so high that top management and stakeholders are convinced that they can do without such a function? This could be explored in a study explicitly examining IA as part of the Management Control System. Research like that may greatly enhance our understanding of the role of IA in organizations.

In any case, it is necessary to delve deeper into the issue of why some organizations have IA while others do not. Perhaps it is just a matter of top management's opinions. Karel Vuursteen, former CEO of Heineken, once stated that he did not believe in IA. "That would make my managers lazy." There is at least some element of truth in that contention. We teach our students at Erasmus University that organizations should be able to get by swimmingly without IA. Because IA is first and foremost a "second opinion function", which is meant to check, control and clarify the "first impressions" of management. In broad, is the Management Control System up to snuff or not?

3. IA's effectiveness

Another totally unexplored area is IA's effectiveness. What does it contribute? What reasons are there to sustain it over many years? Is it just a matter of opinion? My chapters and verses versus yours. Or are there solider measures that could make its contributions more visible and provable? For example, do companies with IA outperform those without? From the perspective of those in the profession it is imperative to bundle evidence and firm things up under the feet so IA can take a stand and say with conviction, "This is what we do. This is how we do it. And this is why." Otherwise, it will continue to be subject to the whims of not only whoever runs it, but also its own.

As already mentioned in Chapter 1 and again above, I started off with the idea of researching "added value". But I rejected it because of what I perceived as grave, possibly even fatal, difficulties. Perhaps stouter hearts will not be deterred so easily. It will be tough going and at times seem impossible. But just think of the great glory and rewards if you succeed.

Apart from IA's contributions to the greater perspective of the organization's performance, there is the issue of measuring its effectiveness and efficiency. How can board members - Management and Supervisory - be sure that they are squeezing the most out of the function? As already shown in this thesis, there is room for improvement. As a professional I have had the privilege of being asked to investigate this matter, and have always found myself feeling my way in the dark. It is my sincere wish and hope that with further research about some of the questions raised in this thesis that I and people in similar situations will have something more substantial and substantiated to back up their convictions and arguments than "I think so" and "I believe".

Nederlandse Samenvatting (Dutch Summary)

Financiële schandalen zijn van alle tijden. Vanwege de groeiende economie en de schaalgrootte van veel organisaties zijn de bedragen die gemoeid waren met die schandalen alleen maar groter geworden. Velen zullen zich de bekende namen herinneren: Enron, Worldcom, Adelphia, Tyco, Ahold, Parmalat, Shell. En de lijst kan nog pagina's lang doorgaan. Aandeelhouders in die bedrijven hebben zeer aanzienlijke bedragen verloren. De overheid heeft initiatieven genomen om de beheersing en transparantie van ondernemingen te verbeteren.

Vanaf het laatste decennium van de vorige eeuw tot op heden zijn er in vele landen dan ook rapporten verschenen inzake het thema Corporate Governance. Corporate Governance is te duiden als 'goed bestuur', waarbij het oogmerk is om te zorgen dat organisaties goed bestuurd worden en dat daarover verantwoording wordt afgelegd aan belanghebbenden. In aanvang was het merendeel van die rapporten bedoeld voor beursgenoteerde ondernemingen, waarbij de verhoudingen tussen aandeelhouders en de organisatie en haar toezichthoudende organen, zoals de Raad van Commissarissen, werden beschreven. Inmiddels hebben in veel andere sectoren, ook in de publieke sfeer, vergelijkbare rapporten het licht gezien.

Eén van de beheersingsinstrumenten, die de Raad van Bestuur/Directie in veel organisaties ter beschikking staat, is de Internal Audit Functie (IAF) IAF's voeren namens het hoogste management onderzoeken uit gericht op diverse objecten zoals: financiële verantwoordingen, processen, naleving van wet- en regelgeving, fraude, informatiesystemen, etc. Het oogmerk daarbij is vaststellen of alles gaat zoals het behoort te gaan. Uiteraard is het management daar zelf verantwoordelijk voor. Maar deze functie dient daarbij als een extra waarborg om hen zekerheid te geven dat alles op orde is.

Mijn interesse gaat al jaren uit naar het functioneren van beheersingsinstrumenten in het algemeen en Internal Audit in het bijzonder, zowel professioneel als theoretisch. In dat laatste geval als eindverantwoordelijke voor de postinitële opleiding Internal/Operational Auditing aan de Erasmus Universiteit Rotterdam. Op zoek naar een geschikt onderwerp voor promotieonderzoek was dan ook al snel duidelijk dat de combinatie van Corporate Governance en Internal Audit het thema zou worden. Het vraagstuk van mijn onderzoek was dan ook de vraag wat de invloed is van de ontwikkelingen op het terrein van Corporate Governance op de rol, positie en taakopdracht van Internal Audit. Vragen die zich aandienden waren onder andere: heeft de functie aan belang gewonnen; is ze andere onderwerpen ter hand gaan nemen; zijn de verhoudingen met het hoogste management en de toezichthouders veranderd: is ze in omvang toegenomen?

Het is van belang op te merken dat dit onderzoek is uitgevoerd binnen de context van het Rijnlandse governance model dat uitgaat van een strikte scheiding tussen Raad van Bestuur/Directie en de toezichthouders in de Raad van Commissarissen. Dit model wordt ook wel 'two-tier' (twee lagen) model genoemd, dit in tegenstelling tot het Angelsaksische model, waarbij bestuurders en toezichthouders in één gezamenlijke vergadering bij elkaar komen en besluiten nemen. Dit model wordt ook wel 'one-tier' (één laag) genoemd.

In hoofdstuk 1 wordt het onderzoek ingeleid. Een onderzoek noopt tot het maken van keuzes met welke bril gekeken zal gaan worden. De praktijk die waargenomen zal gaan worden moet beoordeeld worden aan de hand van een normatief kader, een kader waarmee de waarnemingen geduid kunnen worden en op grond waarvan verdere theorievorming mogelijk is. Besloten werd om te kiezen voor twee bekende theorieën, die ten grondslag liggen aan het denken over organisatiebesturing en Corporate Governance; dit zijn Agency Theory en Transaction Cost Economics.

Agency Theory gaat uit van de scheiding tussen kapitaal en arbeid, waarbij aandeelhouders het kapitaal aan de onderneming ter beschikking stelt en aan de managers vraagt hun investering te laten bloeien en groeien. De aandeelhouder heet de principaal en de manager de agent. De principaal heeft vervolgens tenminste twee problemen: hoe weet ik dat de agent geen dingen doet die mij niet welgevallig zijn (hidden action). En hoe weet ik of de agent mij de juiste dingen vertelt over de uitkomsten van zijn inspanningen (hidden information). Beide problemen worden aangeduid onder de verzamelnaam 'Information Asymmetry', ongelijkheid van informatie. De agent weet meer dan de principaal. Informatie Asymmetrie leidt tot de behoefte bij de principaal om gerust gesteld te worden door middel van controleurs. Wij noemen die controleurs in het jargon 'auditors'. Auditors zijn er ruwweg in twee soorten: een externe auditor, die wordt aangesteld door de Raad van Commissarissen en die tot taak heeft de financiële verantwoording op haar betrouwbaarheid te toetsen. De andere is de internal auditor, die namens de leiding van de organisatie tot taak heeft na te gaan of het lagere management zich houdt aan de afspraken en de juiste dingen doet en een juiste verantwoording aflegt. Daarmee is dan op haar beurt de leiding weer in staat aan de toezichthoudende organen zoals de Raad van Commissarissen verantwoording af te leggen.

Transaction Cost Economics is een theorie die een verklaring wil bieden voor de relatie tussen de activiteiten van de organisatie en de gekozen organisatievorm en bijbehorende beheersingsinstrumenten. Kortweg: welke organisatievorm en beheersingsinstrumentarium past het best in welke omstandigheden? Onderzoek heeft aangetoond dat voor dat keuzevraagstuk drie kenmerken van de activiteiten – ook wel transacties genoemd – bepalend zijn: 1. de mate waarin de productiemiddelen en de daarmee gepaard gaande investeringen specifiek zijn voor het uitvoeren van die transacties (Asset Specificity); 2. de onzekerheid waarmee die activiteiten zijn omgeven (Uncertainty); en 3. de frequentie waarmee de transactie wordt herhaald (Frequency). Van deze drie kenmerken heeft de eerste, 'Asset Specificity", de meest voorspellende waarde.

In het vervolg van het onderzoek zijn die twee theorieën gehanteerd als referentiekader en is getracht met Information Asymmetry en Asset Specificity gepoogd de theorievorming rondom Internal Auditing te verrijken.

Hoofdstuk 2 geeft een overzicht van de status van Internal Auditing op dit moment. Daar wordt aangegeven wat internal audit is en wat de kenmerken van een auditor zijn. Auditing is het toetsen van een werkelijkheid aan een vooraf gedefinieerde norm. Een auditor beschikt over kennis en expertise om een audit zo'n toets uit te voeren. Hij is dan ook een professional. Een belangrijk kenmerk van een auditor is dat hij onafhankelijk hoort te zijn van hetgeen hij onderzoekt. Onafhankelijkheid wordt gezien als een belangrijke hoeksteen van de professie. Maar sinds het niet eenvoudig te definiëren is, noemen sommigen het de achilleshiel van het beroep. De kenmerken waarmee onafhankelijkheid wordt omschreven omvatten begrippen als objectiviteit, integriteit, rechte rug, zorgvuldigheid, competent, etc. Alle begrippen zijn vervolgens ook op hun beurt niet eenvoudig te definiëren.

Voor Internal Audit wordt het van groot belang geacht dat ze verantwoording verschuldigd zijn aan de hoogste leiding zodat de organisatorische positie een groot gewicht krijgt bij het zekerstellen van onafhankelijkheid. Van oudsher is de functie een instrument in de handen van de Raad van Bestuur/Directie en niet in de handen van de Raad van Commissarissen. Onder druk van de Corporate Governance rapporten, met name die uit de one- tier omgeving, wordt in toenemende mate van toezichthouders verwacht dat zij zich rekenschap geven van en bemoeienis hebben met Internal Audit. Hiermee dreigt een zeker rolconflict te ontstaan voor internal auditors. Wie is nu precies de baas? Sommige externe toezichthouders, zoals de Autoriteit Financiële Markten, willen ook inzicht hebben in het werk van Internal Audit, waarmee het aantal potentiële 'bazen' tot drie dreigt uit te groeien. Internal auditors kunnen zich in ieder geval verheugen in meer belangstelling voor hun functioneren.

Hoofdstuk 3 behandelt de meest relevante Corporate Governance rapporten. Inmiddels is een Internal Audit Functie verplicht geworden voor ondernemingen die genoteerd zijn aan de New York Stock Exchange, al of niet intern dan wel in uitbestede vorm. Ook verzekeraars in de US die vallen onder het toezicht van de Federal Deposit Insurance Companies Act dienen daarover te beschikken. In de UK dient een beursgenoteerde onderneming die zo'n functie niet heeft jaarlijks te evalueren of dat terecht is. In Nederland is in de Tabaksblat code ook aandacht besteedt aan Internal Audit, waarbij de Raad van Commissarissen dient toe te zien op welke wijze de Raad van Bestuur daarmee omgaat. Financiële instellingen onder toezicht van De Nederlansche Bank dienen ook een dergelijke functie te hebben.

In alle rapporten wordt een belangrijke functie toegedicht aan het Audit Committee. Het Audit Committee is een deelverzameling van de Raad van Commissarissen (in de two-tier omgeving) of de non-executives (toezichthouders in een one-tier omgeving). Dit Audit Committee heeft speciaal tot taak toe te zien op de betrouwbaarheid van de financiële verantwoording en de relatie met de externe auditor te onderhouden. In alle rapporten is inmiddels, direct of indirect, zoals bij Tabaksblat, bepaald dat het Audit Committee ook toeziet op het functioneren van Internal Audit. Dit draagt naar verwachting zeker bij tot de onafhankelijkheid van de functioneren maar creëert in een two-tier omgeving dus een potentieel rolconflict. Het is dan ook te verwachten dat de relatie met diverse partijen - zoals de Raad van Bestuur, de Raad van Commissarissen, de externe accountant en externe regelgevers - zal veranderen. Het is ook te verwachten dat de toegenomen aandacht zal leiden tot meer beroepsregels en een verhoogde druk om die strikt na te leven.

Hoofdstuk 4 behandelt Agency Theory en Transaction Cost Economics en de toepassing daarvan in onderzoek op het terrein van Internal Auditing. Agency Theory maakt duidelijk dat beloningssystemen een belangrijk instrument zijn om het gedrag van mensen te beïnvloeden. Transaction Cost Economics maakt duidelijk dat het streven naar efficiëntie ertoe leidt dat gepoogd wordt transactiekosten zo laag mogelijk te laten zijn. Transactiekosten worden gemaakt vanwege het zoeken naar contractpartijen en de onderhandelingen die nodig zijn om een contract af te kunnen sluiten en vervolgens na te kunnen gaan of het contract juist is nageleefd. Het is duidelijk dat hoe complexer de transacties zijn hoe meer transactiekosten dienen te worden gemaakt. De mate van Asset Specificity is daarmee bepalend voor de hoogte van die kosten en voor de organisatievorm en de beheersingsstructuur die zal worden gekozen om het beste met die complexiteit en de daaruit voortkomende problemen om te gaan.

Beide theorieën gaan uit van bepaalde veronderstellingen ten aanzien van de gedragingen van mensen. Mensen zijn 'bounded rational', hun vermogens zijn te beperkt om alle contingenties te kunnen overzien en bovendien is de hoeveelheid informatie ook veel te groot. Mensen kunnen (maar het is niet noodzakelijk) opportunistisch gedrag vertonen, waarbij hun belangen prevaleren en er de neiging kan bestaan de werkelijkheid in hun eigen voordeel aan te passen. Agency Theory veronderstelt dat naarmate Information Asymmetry hoger wordt de behoefte aan audit toe zal nemen en dat die grotere behoefte ertoe leidt dat eerder gekozen zal worden voor het intern institutionaliseren van zo'n functie. Mutatis mutandis voorspelt Transaction Cost Economics dat naarmate Asset Specificity toeneemt hetzelfde effect zal kunnen optreden. De laatste theorie geeft bij monde van haar grootste contribuant Williamson aan dat Internal Audit bovendien altijd het voordeel heeft boven de externe auditor van het zijn van 'one of us'. Agency Theory maakt duidelijk dat ook de auditor een agent is die opportunistisch gedrag kan vertonen, dat op haar beurt weer in banen dient te worden geleid door middel van beloningen en het uitoefenen van toezicht door een monitor. Dit betekent dat op basis van de theorie belonen op grond van prestaties de voorkeur geniet. Bovendien is toezicht door vakmensen zoals de externe auditor een goed idee evenals het hebben van gekwalificeerd personeel en het toepassen van tuchtrecht en naleving van professionele standaarden voor de beroepsuitoefening. De theorie maakt duidelijk dat als beloningsinstrumenten belangrijk zijn voor het beïnvloeden van gedrag het ook voor de hand zou liggen om die onderwerp te maken van de taakopdracht (scope of services) van Internal Audit.

Tot slot is duidelijk geworden dat beide theorieën weliswaar aanknopingspunten bieden voor diverse vraagstukken op het terrein van Internal Auditing maar nog niet direct harde conclusies op kunnen leveren. Daartoe is ook nog veel te weinig onderzoek gedaan.

Hoofdstuk 5 beschrijft de uitgevoerde case studies bij ABN AMRO, Bank Nederlandse Gemeenten (BNG), Informatie Beheer Groep (IB Groep) en TNT. Uit de case studies bleek dat Asset Specificity een belangrijker bijdrage te leveren voor de internalisering van Internal Auditing dan Informatie Asymmetrie. Verder bleek dat geen enkele van de bestudeerde organisaties ooit had overwogen om de functie uit te besteden, zelfs niet voor bepaalde delen. Ook is dat niet overwogen bij de twee financiële instellingen, waar een dergelijke functie weliswaar verplicht is maar niet noodzakelijk intern.

De instrumenten die ingezet kunnen worden om Internal Audit te kunnen monitoren, worden – op een enkele uitzondering na - ook ingezet. Een uitzondering vormt de prestatie gebonden beloning. Slechts in één geval gebeurde dat, de overige organisaties zagen grote bezwaren vanwege de mogelijke negatieve invloed op de onafhankelijkheid van Internal Audit. Een andere uitzondering is het gebruik van tuchtrecht. Organisaties handelen slecht presteren intern af en zullen niet snel aangifte doen bij de beroepsgroep.

Het mede op de Agency Theory gebaseerde idee om Internal Audit zo onafhankelijk mogelijk in de organisatie te positioneren waarbij de Raad van Commissarissen/Audit Committee dus de meest in aanmerking komende instantie zou zijn, wordt niet onderschreven. In één geval werd zelfs duidelijk gemaakt dat indien de functie ooit onder de hoede van de Raad van Commissarissen/Audit Committee zou komen te ressorteren, er direct een nieuwe functie in het leven geroepen zou worden, die uitsluitend verantwoording en verschuldigd zou zijn aan de Raad van Bestuur.

Met betrekking tot de taakopdracht viel op dat door de Raad van Commissarissen/Audit Committee van Internal Audit verwacht werd dat inbreuken door het topmanagement tegen gedragscodes en misbruik van beloningsinstrumenten van een organisatie, aan hen gerapporteerd zouden dienen te worden. Raden van Bestuur vonden dat Internal Audit op dat punt geen taak had en de Raden van Commissarissen/Audit Committees voelden weer niet de behoefte om via het Internal Audit Charter af te dwingen dat Internal Audit zich daarmee mocht inlaten.

De resultaten van een uitgevoerde enquête zijn beschreven in hoofdstuk 6. De enquête, uitgevoerd onder nagenoeg 100% van de Nederlandse organisaties met Internal Auditing, leverde een respons op van tussen de 39% en 66%. Van de acht hypothesen werden er twee ondersteund. Indien Information Asymmetry in een organisatie toenam dan leverde dat een toename op van 13 medewerkers bij Internal Audit (hypothese 5). Indien een organisatie Asset Specific was dan leverde dat een toename op van 25 medewerkers ten opzichte van een organisatie die dat niet was (hypothese 2). Daarmee levert het wel of niet Asset Specific zijn een tweemaal zo hoge toename van het aantal internal auditors op ten opzichte van een hoge mate van Information Asymmetry.

Beide begrippen, Information Asymmetry en Asset Specificity, bleken niet te correleren met het vraagstuk van in- of uitbesteden. Blijkbaar, spelen er andere motieven voor dit vraagstuk een rol. In het geval van Asset Specificity lijkt dat overigens in tegenspraak met eerdere onderzoeken. Hierbij wordt wel aangetekend dat in dit onderzoek niet de mate van Asset Specificity van de Internal Audit activiteiten werd gemeten, maar die van de organisatie waarvan zij deel uitmaakt. De veronderstelling in dit onderzoek is dat deze activiteiten inherent asset specific zijn. Uiteindelijk blijkt iets minder dan 10% van de Internal Auditing activiteiten uitbesteed te worden.

IAF's bleken in 40% van de gevallen korter dan vijf jaar te bestaan en daarmee dus erg jong. De veronderstelling is dat de toegenomen belangstelling voor de functie, op haar beurt weer voorkomend uit de Corporate Governance rapporten, daar debet aan is. Uit de enquête bleek ook dat niet alleen de regelgeving sec daar mede verantwoordelijk voor zou kunnen zijn, maar ook de aanwezigheid van externe toezichthouders. Hoe meer externe toezichthouders er waren, hoe groter Internal Audit bleek te zijn. Dit hoeft geen bevreemding te wekken indien we ons realiseren dat het topmanagement uiteraard geen negatieve opmerkingen van externe toezichthouders wenst te hebben en dus genegen zou kunnen zijn zich zoveel mogelijk moeite te getroosten om eventuele manco's reeds zelf te hebben ontdekt door middel van Internal Audit.

Dat Corporate Governance rapporten in het bijzonder en schandalen in de pers in het algemeen hun invloed hebben doen gelden, bleek uit de toegenomen contacten tussen Raden van Commissarissen/Audit Committees en Internal Audit. Ook kregen zij meer directe opdrachten van hen. Ook bleek de eerder geconstateerde potentiële controverse over die directe contacten statistisch significante verschillen in scores op te leveren tussen enerzijds Raden van Bestuur en Raden van Commissarissen/Audit Committees en anderzijds het hoofd van Internal Audit (Chief Audit Executive).

Dat de directe contacten tussen Raden van Commissarissen/Audit Committees en hoofden Internal Audit gevoelig liggen, bleek ook uit de scores op vraag inzake het hebben van separate vergaderingen tussen die twee buiten de aanwezigheid van de Raden van Bestuur. Overigens, bleek 54% van de hoofden Internal Audit nog nooit zo'n vergadering te hebben gehad. Ook statistisch significante verschillen werden geconstateerd op de vraag of de Raad van Commissarissen/Audit Committee betrokken zou moeten zijn bij aanstelling, beoordeling en ontslag van het hoofd van Internal Audit.

Op het punt van prestatie gebonden beloning, bleek dat dit in 55% van de gevallen gebeurde. De overige elementen waarmee de functie kan worden gemonitord bleken in het merendeel van de gevallen toegepast te worden. Verrassend is nog wel dat slechts 64% van de IAF's de Professional Standards van de beroepsgroep blijkt te onderschrijven.

In de afgelopen jaren blijkt de taakopdracht op enkele punten bijgesteld te zijn. Zo loopt het aandeel van Financial Audits terug van 31 naar 23% en loopt het percentage Compliance Audits op van 8 naar 12. Allen de laatste bleek statistisch significant te verschillen over de jaren. Operational Audits en IT Audits blijken behoorlijk stabiel met percentages van respectievelijk rond de 35% en 15%. Consulting bleek ook een redelijk stabiele uitkomst te zien te geven van zo'n 10%.

Tot slot bleek ook de relatie met de externe auditor intiemer geworden te zijn en die relatie zal naar verwachting nog verder intensiveren.

In hoofdstuk 7 worden conclusies getrokken en aanbevelingen gedaan voor verder onderzoek.

Ten aanzien van de **rol** is ten aanzien van de bestaansgrond van Internal Auditing aangetoond dat op grond van de Agency Theory er redenen te vinden zijn waarom deze activiteiten plaats vinden. In diverse Corporate Governance rapporten wordt melding gemaakt van de noodzaak tot het hebben van zo'n functie. In diverse gevallen, zoals beursgenoteerd zijn aan de New York Stock Exchange of het een bank en/of verzekeraar, is deze functie verplicht gesteld door regelgevers/toezichthouders. In alle gevallen is uitbesteding overigens toegestaan. In dit onderzoek is ook aangetoond dat er een positieve correlatie bestaat tussen het aantal internal auditors werkzaam in de functie en het aantal regelgevers/toezichthouders waaraan een organisatie is blootgesteld.

Opvallend is nog dat 40% van de IAF's korter dan 5 jaar bestaat, waarbij voorzichtig gesteld zou kunnen worden dat de toegenomen belangstelling die de laatste jaren voor de functie aan de dag is gelegd – vooral in Corporate Governance rapporten – hier mede debet aan zou kunnen zijn.

In dit onderzoek is geen relatie aangetoond tussen Asset Specificity en Information Asymmetry van de organisatie waarin Internal Audit activiteiten plaatsvinden en de mate van in- of uitbesteding ervan. Uitbesteding van Internal Audit activiteiten bleek voor ongeveer 10% van het totaal te geschieden. Verder onderzoek is nodig voor het vraagstuk van in- of uitbesteding.

Ten aanzien van de **positie** is geconstateerd dat onafhankelijkheid van grote waarde wordt geacht, waarbij dat overwegend wordt gevonden in het hebben van een organisatorische positie direct onder het hoogste management. Op grond van de Agency Theory zou het de voorkeur hebben om het hoofd Internal Audit direct te laten rapporteren aan de Raad van Commissarissen/Audit Committee. Alhoewel in de internationale – lees 'one-tier' omgevingen - Corporate Governance rapporten gekozen is voor een directe lijn met het Audit Committee is dat in de Nederlandse Tabaksblat code niet gebeurt. Bedenk daarbij dat hier een 'two-tier' structuur bestaat. Desalniettemin is ook in Nederland een trend waarneembaar waarbij de Raad van Commissarissen/Audit Committee zich meer bemoeit met het functioneren van Internal Audit.

Een potentieel rolconflict zou daarbij kunnen ontstaan. Een duidelijke keuze zou voor alle betrokkenen de voorkeur hebben. Daarbij kan de theorie richtinggevend zijn. Indien aan de Raad van Bestuur gerapporteerd wordt, verdient rapportage aan de voorzitter de voorkeur.

Met betrekking tot de omvang is in dit onderzoek aangetoond dat Asset Specificity een tweemaal zo grote toename van de omvang van de functie tot gevolg heeft ten opzichte van Information Asymmetry.

De wijze waarop de functie beheerst wordt is grotendeels te verklaren vanuit Agency Theory. De op grond van de theorie te verwachten instrumenten worden weliswaar alle toegepast maar de volgende instrumenten leverden lage scores op:

- ❖ Het gebruik van een ethische code (verplicht op grond van de professionele standaarden overigens) geschiedt slechts in 38% van de gevallen;
- ❖ Steekproefsgewijze controles door de externe auditor gebeurt ook in slechts 38% van de gevallen; dit zou echter te compenseren zijn door;
- ❖ Gebruik te maken van een externe review door een derde partij (ook voorgeschreven in de professionele standaarden) maar dit geschiedt slechts in 30% van de gevallen;
- ❖ Het beoordelen van de functie op grond van meetbare criteria gebeurt in slechts 40% van de gevallen, waarbij het opvallend is dat in ongeveer 55% van de organisaties resultaat gerelateerde beloning van het hoofd Internal Audit plaats vindt waar toepassing van de resultaten van onderzoek gebaseerd op Agency Theory 100% zou kunnen rechtvaardigen;
- ❖ Interne sancties bij niet goed presteren worden in slechts 34% van de organisaties toegepast; en het deponeren van een klacht bij de beroepsorganisaties geschiedt maar in 13% van de gevallen.

De **taakopdracht** heeft de afgelopen jaren nauwelijks significante veranderingen ondergaan. Slechts Financial Audit en Compliance Audit zijn statistisch significant in omvang gewijzigd. Financial Audit gaat over 2001, 2004 en 2007, terug van 31% naar 25% en tot slot naar 23% van de totale tijdsbesteding. Compliance Audit vertoont een stijging van respectievelijk 8% naar 10% en uiteindelijk naar 12% in 2007.

Op grond van de Agency Theory zou verwacht worden dat het gebruikte beloningsinstrumentarium voor het topmanagement onderwerp van audits zou zijn, maar dit blijkt niet of nauwelijks te gebeuren (2% in 2004). Dat laatste geldt ook voor de zogenaamde 'tone at the top' audits, die slechts 1% van het totaal aan Internal Audit activiteiten in 2004 uitmaken. Hier was wel een verschil van inzicht te constateren tussen de wensen van de Raad van Commissarissen/Audit Committee, die wel verachten daarover gerapporteerd te krijgen ingeval van problemen, en de Raad van Bestuur die geen taak voor Internal Audit ziet weggelegd op dit terrein.

De relatie met de externe auditor is geïntensiveerd. Statistisch significant waren: het delen en gezamenlijk opstellen van planningen en het delen van rapporten. De internal auditor monitort de externe auditor vaker. Alhoewel niet statistisch significant, toonden nagenoeg alle andere aspecten van de relatie tussen beide functies een toename.

Tot slot is duidelijk geworden dat wetenschappelijk onderzoek op het terrein van Internal Audit nog in de kinderschoenen staat en dat veel meer onderzoek noodzakelijk is om de theorievorming verder inhoud te kunnen geven. Wellicht dat andere theorieën zoals Resource Based View (RBV) verdere aanknopingspunten kunnen bieden.

Biography

Leen Paape is 51 years young, married to Annette, and has four children, Iris (23), Thomas (22), Amber (10), and Jasper (8). In his 'spare' time he likes to read, cook, play the piano, and fitness.

Leen is Managing Director and Associate Professor for the Postgraduate Program 'Internal/Operational Auditing' at Erasmus University Rotterdam. This is a two-year program that has been awarded (one out of a total of 4 globally) 'Centre of Internal Auditing Excellence' by the Institute of Internal Auditors Inc., the international body connecting over 140,000 internal auditors globally. He is also responsible for the 'accounting information systems' curriculum of the chartered accountants program. He is a member of the Advisory Panel for the MSc program at Cass Business School in London. Leen also chairs the Program Committee for the IIA International Conference 2007 in Amsterdam.

On a part-time basis, Leen is Executive Director for Protiviti Independent Risk Consulting in The Netherlands, and responsible for building the Governance, Risk & Compliance, and Internal Audit practice. After having been Partner within the Advisory practice of PricewaterhouseCoopers for almost a decade, Leen decided upon turning 50 to swap careers. His main focus was the Financial Services industry. During those 10 years Leen has led many projects involving the development of internal audit functions, co-sourced internal audit engagements, Quality Assurance Reviews, building business control frameworks, risk management systems, implementing corporate governance codes like Sarbanes Oxley, Tabaksblat, and the like. He has been member of the Global Internal Audit Leadership Team and chaired the Basel II team in the Netherlands.

Previously, he worked for KLM Royal Dutch Airlines for 9 years as Controller, Senior Management Consultant, and Head of Operational Audit. Prior to that Leen signed off annual reports for KMG Klynveld.

Leen has an early background in the armed forces. He was educated at the Royal Military Academy at Breda and graduated in 1980. He graduated from the Dutch Institute of Chartered Accountants (RA) in 1984 and he was endorsed to become a Chartered Operational Auditor (RO) in 1996. Since 1999 he is also Certified Internal Auditor (CIA). He is an active member of the Dutch Charter of the Institute of Internal Auditors in the Netherlands (IIA), the Dutch Charter of Chartered Operational Auditors (VRO) and the Dutch Association of Chartered Accountants (Royal NIVRA).

He is a sought after chairman for conferences and seminars and a speaker at conferences both nationally and internationally. He published many articles on governance, auditing and risk management.

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Appendix 1: Overview of preliminary results based on the study of Agency Theory and Transaction Cost Economics

The preliminary results based on the literature research are grouped along the same dimensions of Role, Position, and Scope of Services.

Role

1. IA can be seen as an instrument that could provide more information about agents' actions and results of agents and, therefore, help mitigate agency problems.
2. Asset Specificity is an explanatory factor for the existence and size of IA. When Asset Specificity increases it very probably leads sooner rather than later to a "make" decision.
3. Due to enhanced levels of testing and liability claims, external audit is more expensive and better than internal audit.
4. In high risk situations - when, say, there is the possibility of being slapped with major liability claims when shortcomings in control systems are not detected on time - outsourcing is an option sooner rather than later. Because one is looking for the best auditor (presumably the external auditor) and the one with the deepest pockets.
5. The more difficult it is to observe agents' actions and results (hidden information and hidden actions) the greater the need for IA.
6. Asset Specificity, specifically the knowledge required to perform top quality audits, is the major contributing factor for IA's size.
7. If outsourcing is the choice, a qualified in-house staff member is required to supervise how it performs.
8. When outsourcing is the choice, it is recommended to split audits into different phases and the work among competing parties.
9. The higher the need for specialized knowledge of the company, the sooner IA will be in-sourced.
10. The larger the size of the organization the sooner economies of scale allow for in-sourcing IA.

Position

11. Based on theory, IA's organizational position needs to be optimized. Reporting to the Supervisory Board/Audit Committee seems to be the best solution to the problem.
12. IA's size is dependent on the size of the company, the use of subjective and objective incentive schemes and performance based contracts, the trade off between external and internal auditors and the risk management is willing to face. Theory offers no clues whatsoever for IA's absolute size.
13. To address IA's agency problem the following is important:

a. The use of a code of conduct and adherence to it
b. Internal quality measures
c. It is recommended that appraisal be based on finding shortcomings in the control system and imposing penalties when not discovering important on time.
d. There is a need for ad random checks on IA by EA.
e. Qualified auditors are recommended
f. Credible disciplinary powers are desired
g. Professional Standards of the IIA Inc. need to be adhered to.

Scope of Services

14. According to Transaction Cost Economics, broadening IA's Scope of Services adds value.
15. IA's scope is broader than merely financial audit and creates a unique selling point in comparison with the external auditor.
16. From the perspective of Corporate Governance, the Management Board's behaviour is crucial. Therefore, monitoring it should be part of IA's Scope of Services.
17. Since performance measurement and incentive systems are driving factors for how agents behave and, therefore, crucial for the success of any organization, they are obvious audit objects.
18. The greater the need for specialized knowledge of the company the sooner IA will be called in to assist EA in its tasks.
19. IA can be seen as an instrument that supports management control and helps reduce EA costs.
20. From a cost efficiency perspective, sound coordination between IA and EA is required
21. If Corporate Governance developments follow current trends, this need for coordination will increase.

Appendix 2 Journals surveyed for publications regarding Internal Audit(ing) from 1994 to 2005

	# of publications
1. *Academy of Management Journal*	0
2. *Academy of Management Review*	0
3. *Accounting and Business Research*	3
4. *Accounting Auditing & Accountability Journal*	1
5. *Accounting, Organizations and Society*	3
6. *Administrative Science Quarterly*	0
7. *Advances in Management Accounting*	0
8. *Behavioural Research in Accounting*	2
9. *British Journal of Management*	0
10. *California Management Review*	0
11. *Contemporary Accounting Research*	3
12. *Critical Perspectives on Accounting*	3
13. *International Journal of Auditing*	19
14. *Journal of Accounting & Economics*	0
15. *Journal of Accounting Literature*	0
16. *Journal of Accounting Research*	1
17. *Journal of Economic Behaviour and Organization*	0
18. *Journal of Financial Economics*	0
19. *Journal of Law, Economics and Organization*	0
20. *Journal of Management Accounting Research*	1
21. *Maandblad Accountancy en Bedrijfseconomie* (MAB)	10
22. *Management Accounting Research*	0
23. *Management Science*	0
24. *Managerial Auditing Journal*[91]	155
25. *Organization Science*	0
26. *Sloan Management Review*	0
27. *Strategic Management Journal*	0
28. *The Accounting Historians Journal*	2
29. *The Accounting Review*	1
30. *The Journal of Management Studies*	0
Total number of publications	**204**

[91] The total includes all publications containing some reference to internal auditing. But many of them contained very little that was relevant for this thesis.

Appendix 3: Interview scheme

1. What is your view and opinion on the relationship between Supervisory Board/Audit Committee, Management Board and the IAF and the external auditor in the realm of the current discussions and regulations on Corporate Governance?
    - Will the Audit Committee become a principal of the IAF?
    - How is the Audit Committee to perform oversight of the IAF?
    - Will this enhance or hamper the independence of the IAF?
    - How will the line of communication between the IAF and the Audit Committee be drafted? Will it alter upon these recent regulations?
    - Do the interests of the respective participants in the corporate governance arena differ? If so, in what way? Does it create any problem and if so in what way?
    - Will this affect the relationship with the External Auditor and if so in what way?
    - What is your view with regard to the difference between the one tier and two tier system? Will there be a convergence?

2. What happened to the Audit Charter in recent history? Was it changed?
    - Why?
    - Who delivered input, who decided based on what?
    - Will the IAF be subject to changes due to the newly adopted regulations and initiatives?
    - Will this affect the relationship with the external auditor and if so in what way?

3. What are your views on the independence issue of the IAF?
    - Will there be an effect due to the changes in regulations on the current structure of the IAF?
    - What is your view with regard to the hiring, firing and appraisal of the Chief Audit Executive?
    - Is there a need to pay the Chief Audit Executive based on a performance-based contract?
    - Do you expect that rules imposed on external auditors (oversight, peer reviews, quality systems, rotation, disciplinary powers, etc.) will be made applicable to internal auditors as well?

4. Make or buy issue
    - What is your view on the topic 'make or buy'? Will that be affected by Corporate Governance regulations and the enhanced interest by the Audit Committee?
    - Which criteria are most important to come to a decision?

5. Would you be so kind to complete the attached short questionnaire? I estimate that it will take you no more than 15 minutes to finish it.

Appendix 4: Transaction Cost Economics and Agency Theory Questionnaire

Characterization of your organization:

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	**D**	**N**	**A**	**SA**
Our services and products vary significantly					
Our services and products require very specialized knowledge					
Our brand name is very important and difficult to build					
Our organization has very specific attributes that makes it unique					
Investments in assets depend upon the specific character of the transactions and contracts					
Our location is tied to the location of our suppliers and/or customers					
Uncertainty with regard to the specifications of our services and products is high					
Our processes need to be adapted regularly because we do not know up front how to deliver (custom made)					
Activities and processes are largely programmable and predictable					
Demand for our services varies significantly					
It is difficult to monitor the processes and activities					
The organization is subject to regular changes					
The organization faces great risk					
Complexity of our processes is high					
Problems that occur require structured solutions					
Problems that occur are solved on an ad hoc basis					
Frequency of problems and bottlenecks is high					
Our processes have a high repetition rate					
It is difficult to monitor the activities of lower level managers					
It is easy to assess the reliability of information provided by lower level management					
Even after completion it is not easy to assess whether the contract has been met					
Outcome of processes can be measured quite easily					
Customers cannot easily assess whether the contract has been met					
It isn't easy for superiors to assess the adequacy of reporting by lower level managers					

Bold printed questions are related to Transaction Cost Economics attributes, the others to Information Asymmetry.

Appendix 5: Questionnaire used in the case studies

Characterization of your organization:

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	**D**	**N**	**A**	**SA**
Our services and products vary significantly					
Our services and products require very specialized knowledge					
Our brand name is very important and difficult to build					
Our organization has very specific attributes that make it unique					
Investments in assets depend upon the specific character of the transactions and contracts					
Our location is tied to the location of our suppliers and/or customers					
Uncertainty with regard to the specifications of our services and products is high					
Our processes need to be adapted regularly because we do not know upfront how to deliver (custom made)					
Activities and processes are largely programmable and predictable					
Demand for our services varies significantly					
It is difficult to monitor the processes and activities					
The organization is subject to regular changes					
The organization faces great risk					
Complexity of our processes is high					
Problems that occur require structured solutions					
Problems that occur are solved on an ad hoc basis					
Frequency of problems and bottlenecks is high					
Our processes have a high repetition rate					
It is difficult to monitor the activities of lower level managers					
It is easy to assess the reliability of information provided by lower level management					
Even after completion it is not easy to assess whether the contract has been met					
Outcome of processes can be measured quite easily					
Customers can not easily assess whether the contract has been met					
It isn't easy for superiors to assess the adequacy of reporting by lower level managers					

Based on the Corporate Governance regulations IA will:

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	**D**	**N**	**A**	**SA**
Become a mandatory function					
Be a function that is present in organizations					
Gain in stature					
Get a more limited scope of services					
Be supervised by the Audit Committee (or Supervisory Board)					
Be less independent					
Have more work to do					
Take into account other stakeholders					
Provide less assurance with regard to the reliability of financial statements					
Provide more assurance with regard to the reliability of non-financial information					
Provide more assurance with regard to the reliability of processes					
Provide less assurance with regard to the reliability of information systems					
Provide more assurance with regard to ethics and conduct					
Be more compliance oriented					
Provide less assurance with regard to the prevention of fraud					
Provide more assurance with regard to the efficiency of the organization					
Provide less assurance with regard to the effectiveness of the organization					
Provide more assurance with regard to the way the Board operates					
Provide less assurance with regard to business risks					
Provide more assurance with regard to the change management					
Provide less assurance with regard to the use of incentives systems					
Provide more assurance with regard to the work of the external auditor					
Provide less assurance with regard to the correctness of decisions taken					
Be more involved in environmental auditing					
Be more involved in quality auditing					
Be an increasing source of knowledge					
Become a nursery function for management					

Gain in professionalism					
Have less communication with the external auditor					
Cooperate more with the external auditor					
Provide less consultancy					
Suffer cut down in budget					
Become more subject to review and disciplinary powers by the profession					
Become less liable					
Be vulnerable to reputation loss					
Give account upon their actions					
Serve more than one master					
Be outsourced to a party other than the own external auditor					
Be outsourced to the own external auditor					
Gain in size					
Be staffed with management potentials and former managers					
Have a different organizational position and become more independent					
Need to cooperate less with the external auditor					
Contain different disciplines					

IA's independence is enhanced by:

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	**D**	**N**	**A**	**SA**
Reporting to the Chief Executive Officer					
Reporting to the Chief Financial Officer					
Reporting to the Controller					
Reporting to the Audit Committee					
Reporting to the Supervisory Board					
Head of Internal Audit meeting the Audit Committee privately					
Head of Internal Audit having performance based incentives					
Head of Internal Audit being hired and fired by the Supervisory Board/Audit Committee					
Independent reporting to monitoring bodies outside the company					

The wages and bonuses being defined by the Supervisory Board					
Cost of audits being billed to the auditees					
Peer reviews by the professional bodies					
Clear rules provided by professional bodies					
Results of audits being used to appraise management					
Active supervision by bodies like the SEC, AFM, *De Nederlandsche Bank* (DNB), etc.					
Serving as a nursery function					
Using Internal Audit in change processes					
Having client satisfaction surveys					
Auditors being involved in interim management					
The external auditor assessing the adequacy of Internal Audit					
Good cooperation between Internal Audit and external auditor					
Performing joint audits with the external auditor					
Having to contribute to the efficiency of the organization					
Delivering consultancy services					

I do expect the following to happen with regard to the relationship with the external auditor:

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	D	N	A	SA
The need for coordination will increase					
The need of joint reporting will decrease					
The need for joint audits will increase					
The need for cooperation will decrease					
The gap between Internal and External audit will expand					
External audit will monitor the adequacy of internal audit more frequent					
Internal audit will monitor external audit more extensively					
Other, please specify					

Audit Committees not only need to exercise oversight of external audit but also to internal audit. What will be, in your view, the consequences?

(SD = strongly disagree, D = disagree, N = neutral, A = agree, SA = strongly agree)

	SD	**D**	**N**	**A**	**SA**
More requests from the Audit Committee					
Less requests from the Board of Management					
Different reporting formats for the Board versus the Audit Committee					
More formal communication by internal audit					
Tension may arise for internal audit (serving two masters)					
Internal Audit may become alienated from the rest of the organization					
Internal Audit will report less					
The Audit Committee may become a principal of Internal Audit					
The scope of services of Internal Audit may decrease					
Quality of Internal Audit will rise					
Communication with the external auditor will decrease					
Internal Audit will have a larger budget					
The interest for the work of Internal Audit will be enhanced					
The Audit Committee will do the hiring and firing of Internal Audit					
Tension between the external and the internal auditor may increase					
Outsourcing will increase					
Otherwise, please specify					

Appendix 6: Survey questionnaire for Chief Audit Executives (final version)

Questionnaire for Heads of Internal Audit

(Relating to the PhD thesis of Leen Paape, Erasmus University, Rotterdam, The Netherlands)

Please return preferably before November 12, 2004

Please Circle Your Answers where appropriate.

Questions relating to who is supplying the answers:

1. Who are you?

a. Head of Internal Audit, or in a comparable role.
b. Some other function. Please specify.
…………………………………………………………………………………

Questions relating to your organization:

2. Are you listed on the stock market?

a. No.
b. Yes. We are listed on ……………………………………………………….

3. What system of Corporate Governance does your organization have?

a. One tier (combined board of executives and non-executives).
b. Two tier (separate Management and Supervisory Board).

4. Do you have an Audit Committee or a comparable oversight structure?

a. No.
b. Yes, and that is comprised of:

1. Exclusively independent members (independent of the organization).
2. A majority of independent members.
3. Half are independent members, half of them are from within the organization.
4. A minority of independent members.
5. Exclusively of members that come from within the organization.

c. The Audit Committee or comparable oversight structure has existed since:
……… (year).

5. In what areas is your organization active?

a. Trade, transport, logistics.
b. Production, energy, utilities.
c. Telecommunications, information technology, media and entertainment.
d. Professional services.
e. Financial services (banking, insurance, pension funds, etc.).
f. Public sector (government, "*agentschap*", "*zelfstandig bestuursorgaan*", etc.).

6. How large is your organization?

i. Turnover for 2003.

a. Less than € 50 million.
b. Between € 51 and € 100 million.
c. Between € 101 and € 500 million.
d. Between € 501 million and € 1 billion.
e. More than € 1 billion.

ii. Total assets at the end of 2003.

a. Less than € 25 million.
b. Between € 26 and € 50 million.
c. Between € 51 and € 100 million.
d. Between € 101 million and € 500 million.
e. More than € 500 million.

iii. Numbers of employees at the end of 2003.

a. Less than 500.
b. Between 501 and 1,000.
c. Between 1001 and 2,500.
d. Between 2,501 and 10,000.
e. More than 10,000.

How relevant are the following propositions in characterizing your organization? Your answers can range from not at all applicable (1) to very much so (5).

7. Our products and services are largely made based on the specific requirements of our clients.	1	2	3	4	5
8. The production of our products and services requires highly specialized knowledge.	1	2	3	4	5
9. Our brand name is extremely important.	1	2	3	4	5
10. It cost a lot of time and effort to build our brand.	1	2	3	4	5
11. Our assets are so specific for our company that they couldn't be broken up or disposed of without huge losses.	1	2	3	4	5
12. The location of our organization is linked to the locations of our customers and suppliers.	1	2	3	4	5
13. It is very difficult to specify in advance exactly what standards our products and services must comply with.	1	2	3	4	5

14. In order to understand our processes much knowledge of and experience in our organization is required.	1	2	3	4	5
15. The knowledge of our employees is very much organization-specific and is not immediately transferable to another organization.	1	2	3	4	5
16. It is difficult for top management to determine the reliability of reports coming from below.	1	2	3	4	5
17. It is not at all simple to measure the results of our processes and activities.	1	2	3	4	5
18. For managers it is not easy to observe whether or not employees are adequately fulfilling their tasks.	1	2	3	4	5
19. For customers of our products/services it is difficult to determine if they measure up to what was agreed on in advance.	1	2	3	4	5
20. For us, it is also difficult to determine whether products or services measure up to what was agreed on in advance.	1	2	3	4	5
21. More than once a year the Management Board is confronted with developments that are different than what they were led to expect from previous reports.	1	2	3	4	5

22. How many management levels are there between the Management Board and the shop floor?

    a. One.
    b. Two.
    c. Three.
    d. Four.
    e. Five or more.

23. Do you have an Internal Audit Function?

    a. Yes, since ………….. (year)

    b. No. You can stop here.

In the last 3 years the following has happened with Internal Audit in my organization:

	Strongly agree				Strongly disagree
24. Has been shrinking in terms of size.	1	2	3	4	5
25. Has more consultations with the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
26. Has received less assignments from the Management Board.	1	2	3	4	5
27. Has received more assignments from the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
28. Is cooperating less with the External Auditor.	1	2	3	4	5
29. Has received a bigger budget (10% or more).	1	2	3	4	5
30. More internal audit activities were outsourced to third parties.	1	2	3	4	5
31. The function has been centralized.	1	2	3	4	5

In some Corporate Governance reports outside The Netherlands the Audit Committee (or a comparable structure) is specifically designated to actively oversee Internal Audit in order to optimize its independence. By contrast, the latest Dutch code - Tabaksblat - assigns oversight to the Management Board. Without taking into account the actual situation within your organization, please give us your opinion about the following propositions.

	Strongly agree				Strongly disagree
32. The Head of Internal Audit should be responsible to the Chairman of the Management Board.	1	2	3	4	5
33. The Head of Internal Audit should be responsible to the Chief Financial Officer or Finance Director.	1	2	3	4	5
34. The Head of Internal Audit should be responsible to the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
35. The Head of Internal Audit should have meetings with the Board of Supervisors or Audit Committee (or comparable oversight structure) independent of the Management Board.	1	2	3	4	5

36. Hiring, firing and assessment of the Head of Internal Audit should be done with the approval of the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5

Based on Corporate Governance rules and recommendations being adopted, what changes in Internal Audit do you anticipate in the coming 3 years?

	Strongly agree				Strongly disagree
37. More communication between Internal Audit and Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
38. The Head of Internal Audit will be receiving assignments not only from the Management Board, but also the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
39. A greater distance between Internal Audit and the organization.	1	2	3	4	5
40. Internal Audit will become less independent.	1	2	3	4	5
41. A higher quality of Internal Audit activities.	1	2	3	4	5
42. More tension for the Head of Internal Audit, because more masters have to be served.	1	2	3	4	5
43. Less conferencing with the External Auditor.	1	2	3	4	5
44. Internal Audit's budget will be cut back (10% or more).	1	2	3	4	5
45. The tension between the External and Internal Auditors will increase.	1	2	3	4	5
46. Less outsourcing of Internal Audit activities to third parties.	1	2	3	4	5

47. Anything else? Please specify.
……………………………………………………………………………………………
……………………………………………………………………………………………

Questions relating to approximate size of Internal Audit in your organization (in-house or outsourced) yesterday, today and tomorrow. What was it in 2001? What is it now, in 2004? And according to your expectations, what will it be in 3 years, in 2007?

	2001	2004	2007
48. Total number of internal auditors in your organization.	…….fte	…….fte	…… fte
49. Total budget (including expenses, travel, housing, etc.) for Internal Audit (not including the budget for the External Auditor).	€………	€……….	€………
50. Total insourced in fte's on an annual basis.	……. fte	……. fte	……. fte

51. Who is the Head of Internal Audit responsible to? Again, yesterday, today and tomorrow. In 2001? Now, in 2004? And according to your expectations, in 3 years, in 2007? Check one for every year.

	2001	2004	2007
a. Chairman of the Management Board.	1	2	3
b. CFO or Financial Director.	1	2	3
c. Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3
d. Division Management/Business Unit management.	1	2	3

e. Other. Please specify. …………………………………………………………………..

52. Is there a performance related aspect that helps determine the salary of the Head of Internal Audit (multiple answers possible)?

a. No.
b. Yes, and that is based on:

    1. The organization's financial results.
    2. The organization's non-financial results.
    3. Internal Audit's performance milestones agreed upon up front.
    4. Anything else? Please specify.

    …………………………………………………………………………………….

53. In the past 3 years I have met with the Audit Committee ….. than previously:

a. More often.
b. The same.
c. Less often.
d. Not applicable.

54. The Audit Committee (or comparable oversight structure) speaks/meets with me without the Management Board being present:

a. Yes. Normally, 1 or more times per year.
b. Yes, but only in special circumstances.
c. No, never.

According to your estimates, what percentage of Internal Audit's time is spent on the following different types of audits? In the past, in 2001? Now, in 2004? And according to your expectations, in 3 years, in 2007? (The total in each year column should be 100%.)

	2001	2004	2007
55. Financial audit.	………%	………%	………%
56. Operational audit.	………%	………%	………%
57. IT/EDP audit.	………%	………%	………%
58. Fraud audit.	………%	………%	………%
59. Compliance audit.	………%	………%	………%
60. Ethical audit/tone at the top.	………%	………%	………%
61. Audits about the use of incentive and reward instruments in the organization.	………%	………%	………%
62. Advising/consultancy.	………%	………%	………%
63. Other. Please specify. ………………………………………………………………… …………………………………………………………………	………%	………%	………%
Total	100%	100%	100%

64. The relationship between External and Internal Audit in your organization: yesterday, today and tomorrow. What was the relationship between the two, in 2001? What is it now, in 2004? And according to your expectations, what will it be in 3 years, in 2007 (multiple answers are possible).

	2001	2004	2007
a. No relation.	1	2	3
b. Sharing plans.	1	2	3
c. Joint planning.	1	2	3
d. External Audit monitors Internal Audit.	1	2	3
e. Internal Audit monitors External Audit.	1	2	3
f. Reports are shared between the two.	1	2	3
g. The Management Letter is made together.	1	2	3
h. Internal Audit is put to work in accordance with External Audit's requirements.	1	2	3
i. Internal Audit controls the budget of External Audit.	1	2	3
j. Audits are done together.	1	2	3

k. Other. Please specify:

………………………………………………………………………………………………..

65. Which of the following instruments does your organization have for Internal Audit (multiple answers possible)?

a. A specific ethics code.
b. Audit Charter/Statute.
c. Quality measures (dossier review, standardized work methods, audit work flow software, etc.).
d. Ad random checks by the External Auditor.
e. Independent review by an external party.
f. Appraisal based on measurable criteria.
g. Credentials and qualifications requirements (for example, diplomas).
h. Internal sanctions for poor performance (firing, disciplinary procedures, etc.).
i. Compliance with standards of professional organizations. For example, IIA, Inc. (Institute of Internal Auditors) and the Dutch VRO (Association of Registered Operational Auditors).
j. Under justifiable circumstances official complaints are made to the professional organizations.
k. Other. Please specify. ……………………………………………………….

66. How long does it take before an internal auditor can perform audits independently?

a. Immediately.
b. Less than 3 months.
c. 4-6 months.
d. 7 months to 1 year.
e. Longer than 1 year.

67. Do you wish to receive an electronic copy of the results of this survey?

a. No.
b. Yes, my e-mail address is ....

End of questionnaire. Thank you very much for your cooperation.

Appendix 7: Survey questionnaire for Board Members (final version)

Questionnaire for Management Board or Supervisory Board members

(relating to the PhD thesis of Leen Paape, Erasmus University, Rotterdam, The Netherlands)

Please return preferably before November 12, 2004.

Please Circle Your Answers where appropriate.

1. Who are you?

   a. A member of the Management Board.
   b. A member of the Board of Supervisors or Audit Committee (or comparable oversight structure).
   c. Other. Please specify. ………………………………………………..

In some Corporate Governance reports outside The Netherlands the Audit Committee (or a comparable structure) is specifically designated to actively oversee Internal Audit in order to optimize its independence. By contrast, the latest Dutch code - Tabaksblat - assigns oversight to the Management Board. Without taking into account the actual situation within your organization, please give us your opinion about the following propositions.

	Strongly agree				Strongly disagree
2. The Head of Internal Audit should be responsible to the Chairman of the Management Board.	1	2	3	4	5
3. The Head of Internal Audit should be responsible to the Chief Financial Officer or Finance Director.	1	2	3	4	5
4. The Head of Internal Audit should be responsible to the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
5. The Head of Internal Audit should have meetings with the Board of Supervisors or Audit Committee or comparable oversight structure) independent of the Management Board.	1	2	3	4	5
6. Hiring, firing and assessment of the Head of Internal Audit should be done with the approval of the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5

Based on Corporate Governance rules and recommendations being adopted, what changes in Internal Audit do you anticipate in the coming 3 years?

	Strongly agree				Strongly disagree
7. More communication between Internal Audit and Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
8. The Head of Internal Audit will be receiving assignments not only from the Management Board, but also the Board of Supervisors or Audit Committee (or comparable oversight structure).	1	2	3	4	5
9. A greater distance between Internal Audit and the organization.	1	2	3	4	5
10. Internal Audit will become less independent.	1	2	3	4	5
11. A higher quality of Internal Audit activities.	1	2	3	4	5
12. More tension for the Head of Internal Audit, because more masters have to be served.	1	2	3	4	5
13. Less conferencing with the External Auditor.	1	2	3	4	5
14. Internal Audit's budget will be cut back (10% or more).	1	2	3	4	5
15. The tension between the External and Internal Auditors will increase.	1	2	3	4	5
16. Less outsourcing of Internal Audit activities to third parties.	1	2	3	4	5

17. Anything else? Please specify.
…………………………………………………………………………………..
…………………………………………………………………………………..

18. Do you wish to receive an electronic copy of the results of this survey?

   a. No.
   b. Yes, my e-mail address is ....

End of questionnaire. Thank you for very much for your cooperation.

Appendix 8: Introduction letters to Chief Audit Executives or Board Members

Attn of Members of the Management Board and
Supervisory Board/Audit Committee

Doctorate Research on Internal Audit at Erasmus University, Rotterdam, The Netherlands

Dear Madam/Sir,

As your Head of Internal Audit has undoubtedly assured you by now, the completion of this questionnaire will take about 5 or 10 minutes of your time. All responses will be kept strictly confidential. Since I am making that request of you, you have every right to know what it's all about.

The short answer is this is research in connection with my doctorate thesis at Erasmus University (Rotterdam, The Netherlands) into developments in and around the Internal Audit Function and the influence that changes in Corporate Governance rules and recommendations might have on that. As you are undoubtedly aware, these rules and recommendations are changing rapidly and, in most cases, becoming more stringent. Some believe than Internal Audit can, and is, playing an important role in creating assurance in various areas of corporate life.

I am responsible for the post-graduate program in Internal/Operational Auditing at Erasmus University in Rotterdam. I am a member of the Advisory Panel of a comparable program at the CASS Business School in London. I am an active member of the both the Institute of Internal Auditors (IIA) The Netherlands and the Association of Registered Operational Auditors (Dutch acronym, VRO). What's more, I am a partner with PricewaterhouseCoopers Accountants in The Netherlands.

This research is supported by Erasmus University, IIA, The Netherlands, VRO and PricewaterhouseCoopers.

Your cooperation in this matter is important for obtaining a good insight into the developments around the Internal Audit Function. If you have any questions about this questionnaire, you can contact me at paape@few.eur.nl or 06-536-446-23.

I very much appreciate your cooperation.

Sincerely yours,

Leen Paape RA RO CIA

Attn of Head of Internal Audit

Doctorate Research on Internal Audit at Erasmus University, Rotterdam, The Netherlands

Dear Colleague,

Enclosed within this packet of "goodies" are two separate and distinct questionnaires relating to my doctorate thesis on Internal Audit. The shorter one - of which there are two copies - should be filled out by two different individuals. One, a member of your Management Board, or a manager on your Board of Directors. The other, a member of your Board of Supervisors, a non-executive on your Board of Directors, or a member of the Audit Committee (or comparable oversight structure).

Would you be so kind as to give those people the questionnaires and the accompanying introductory letter meant for them, and ask them to fill it out. It will take about 5 to10 minutes of their time.

The second, somewhat longer, questionnaire is for you as head of Internal Audit - or a comparable function. It will take about 30 minutes of your time. All responses - both yours and those of your colleagues - will be kept strictly confidential. The questions are in English because I have decided to write my thesis in English. However, if you would prefer to receive a Dutch version of these questions, please let me know at the below-mentioned e-mail address or telephone number.

Since I am requesting your help, you have every right to know what it's for. Thus a little background on the nature of my research is in order. During the last years Corporate Governance has increasingly become an interesting topic. Numerous codes - rules or recommendations - have been developed in different countries to rectify, or at least mitigate, disasters. These codes pay some attention to Internal Audit. Sometimes more, more often less.
My research is about the influence of these codes on the Internal Audit Function (IAF).

I am responsible for the post-graduate program in Internal/Operational Auditing at Erasmus University in Rotterdam. I am a member of the Advisory Panel of a comparable program at the CASS Business School in London. I am an active member of both the Institute of Internal Auditors (IIA) The Netherlands and the Association of Registered Operational Auditors (Dutch acronym, VRO).

This research is supported by Erasmus University, IIA, The Netherlands, and the VRO.

Your cooperation in this matter is important for obtaining a good insight into the developments around the Internal Audit Function. It goes without saying - but I'll say it anyway - that I am very grateful for your cooperation and that of your colleagues.

If you have any questions about this questionnaire, you can contact me at paape@few.eur.nl or 06-53644623.

Sincerely yours,

Leen Paape RA RO CIA

Enclosures:

1. One questionnaire (two copies): One to be filled out by a manager (Management Board, Board of Directors); the second by a non-executive: Board of Supervisors, Board of Directors, or Audit Committee (or comparable oversight structure)

2. One questionnaire for the Head of Internal Audit

3. A post-paid return envelope

Appendix 9: Script for the regressions

Minitab version 14 is applied (www.minitab.com).

```
GMACRO

DoAnalysis

Factor 'v16' 'v17' 'v18' 'v21' 'v22'

name c400 'v7d'
let 'v7d' = (v7>=5)
name c401 'v8d'
let 'v8d' = (v8>=5)
name c402 'v9d'
let 'v9d' = (v9>=5)
name c403 'v10d'
let 'v10d' = (v10>=5)
name c404 'v11d'
let 'v11d' = (v11>=5)
name c405 'v12d'
let 'v12d' = (v12>=5)
name c406 'v13d'
let 'v13d' = (v13>=5)
name c407 'v14d'
let 'v14d' = (v14>=5)
name c408 'v15d'
let 'v15d' = (v15>=5)
name c409 'v19d'
let 'v19d' = (v19>=5)
name c410 'v20d'
let 'v20d' = (v20>=5)
name c411 'v66d'
let 'v66d' = (v66>=5)

name c412 'SumAsq3'
let 'SumASq3' = c400+c401+c402+c403+c404+c405+c406+c407+c408+c409+c410+c411
name c200 'AS'
let 'AS' = ('SumASq3' > 2 )

name c420 'v16d'
let 'v16d' = v16
name c421 'v17d'
let 'v17d' = v17
name c422 'v18d'
let 'v18d' = v18
name c423 'v21d'
let 'v21d' = v21
```

```
name c201 'IA'
let 'IA' = (c420+c421+c422+c423)/4

name c202 'FTE_IAD'
let 'FTE_IAD' = v482004

name c203 'FTE_TOTAL'
let 'FTE_TOTAL' = 'total fte'

name c204 'NR_SUPERV'
let 'NR_SUPERV' = 'number of supervisors'

Regress 'FTE_IAD' 3 'FTE_TOTAL' 'NR_SUPERV' 'AS'

Regress 'FTE_IAD' 3 'FTE_TOTAL' 'NR_SUPERV' 'IA'

AOVOneway 'v32' 'v1.1:Survey MB' 'v1.1:Survey SB'

AOVOneway 'v33' 'v2:Survey MB' 'v2:Survey SB'

AOVOneway 'v34' 'v3:Survey MB' 'v3:Survey SB'

AOVOneway 'v35' 'v4:Survey MB' 'v4:Survey SB'

AOVOneway 'v36' 'v5:Survey MB' 'v5:Survey SB'

AOVOneway 'v37' 'v6:Survey MB' 'v6:Survey SB'

AOVOneway 'v38' 'v7:Survey MB' 'v7:Survey SB'

AOVOneway 'v39' 'v8:Survey MB' 'v8:Survey SB'

AOVOneway 'v40' 'v9:Survey MB' 'v9:Survey SB'

AOVOneway 'v41' 'v10:Survey MB' 'v10:Survey SB'

AOVOneway 'v42' 'v11:Survey MB' 'v11:Survey SB'

AOVOneway 'v43' 'v12:Survey MB' 'v12:Survey SB'

AOVOneway 'v44' 'v13:Survey MB' 'v13:Survey SB'

AOVOneway 'v45' 'v14:Survey MB' 'v14:Survey SB'

AOVOneway 'v46' 'v15:Survey MB' 'v15:Survey SB'

ENDMACRO
```

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Corporate Governance

The Impact on the Role, Position, and Scope of Services of the Internal Audit Function

Corporate scandals during the last decade fostered many Corporate Governance reports. These reports aimed at restoring checks and balances in companies to prevent fraudulent behaviour and restore public trust. One of the functions active in many organizations is Internal Audit. This function operates under the umbrella of the Management Board and is geared towards monitoring lower level management. Due to the Corporate Governance reports the interest in the work of internal auditors has increased. In many reports special attention is paid to this function. The Supervisory Board and the Audit Committee are required to oversee the activities and results of external as well as internal auditors. Furthermore, regulators are also keen on the results of their work. The aim of this study was to research the impact of Corporate Governance reports on the role, position, and scope of services of the Internal Audit Function. Agency Theory and Transaction Cost Economics were applied to further theory around internal auditing. Information asymmetry and asset specificity were used to test whether there was a correlation between high scores on information asymmetry and/or asset specificity for the organization and the size of an Internal Audit Function, the 'make or buy' issue, or its scope of services. Results showed that such was the case for the size but not for the 'make or buy issue or the scope of services. Furthermore, this study contains descriptive characteristics of internal audit functions.

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