# Contributions and limits of Internal Auditing to the internal control of the firm

Walter H.A. Swinkels
University of Amsterdam
wswinkels@deloitte.nl

## ABSTRACT

The increased (regulatory) demands for accountability has made the internal control systems of firms part of the public policy debates on auditing and corporate governance (Maijoor, 2000). There is no common concept regarding the internal control of a firm; different concepts for internal control are assumed in various research, dependent of the choice of academic field. No adequate theory exists regarding the role and contribution of internal audit in the internal control of the firm, which hampers adequate development of this popular profession in relation to developments in the economy, in particular micro-economics.

The COSO framework has become the most quoted framework in discussions within corporate governance committees (Corporate Governance Committee, 2008) and regulators (PCAOB, 2004) and professional bodies like the IIA. The COSO internal control framework seems to convince auditors (internal and external), regulators, investors and society of having authority to achieve and to report being *in-control*. Recent problems with a number of firms, some of which published an *in-control* statement on basis of the COSO framework, raises questions with respect to the effectiveness and completeness of the control of these firms, suggesting that possible quintessential elements or aspects are missing?

This paper explains the lack of theoretical basis of the field of internal audit, compares the COSO-framework against a broader, multidisciplinary view of being in control and outlines the development of a theoretical base for internal audit.

*Disclaimer*
*This paper is work in progress and part of my PhD study at the University of Amsterdam. No reference should be made to this paper without the author's explicit authorization.*

# 1 Introduction

When is a firm in control? Many business people, regulators, investors, practitioners in the field of law, audit, consulting as well as many others are concerned with this question. Increased (regulatory) demands for accountability have made firm's internal control systems part of the public policy debates regarding auditing and corporate governance (Maijoor, 2000). There is no common concept regarding the internal control of a firm; different concepts for internal control are assumed in various research, depending of the academic field involved. No adequate theory exists regarding the role and contribution of internal audit in the internal control of the firm, which hampers adequate development of this popular profession in relation to developments in the economy, in particular micro-economics.

The attention to the *in control* question relates to the scandals and financial crises within public companies that have undermined investor and shareholder confidence in the management of companies that operate in financial markets (Corporate Governance Committee, 2003; p. 67). These scandals cleared the way for corporate governance committees and reports. This is why internal control of a firm is mostly examined under the umbrella of so-called *corporate governance*.

Enron, Worldcom and other US scandals resulted in the Sarbanes-Oxley Act, which requires multinationals listed on the US stock exchange to report on the effectiveness of their internal controls (Sarbanes & Oxley, 2002). The main focus is the internal control over financial reporting, which is a specific and limited view on internal control. However, these internal control statements have not prevented new scandals within US companies, like AIG, who excluded risk management and internal audit from some of their critical control issues. The Committee on Oversight and Government Reform held a hearing to examine the regulatory mistakes and financial excesses that led to government bailout of AIG; through reports and Audit Committee meeting reports, they demonstrated a lack of governance and transparency at AIG (COGR, 2008, October 7).

The UK has bundled its corporate governance reports into the Combined Code (FRC, 2006). Their approach based more on principle, the purpose being to achieve the requisite high standard of corporate behaviour within companies. However, this code did not prevent a recent scandal at HBOS regarding "inadequate 'separation' and 'balance of powers' between the executive and internal and external oversight bodies, i.e. finance, risk, compliance and internal audit, non-executive Chairmen and Directors,

external auditors, the FSA, shareholders and politicians" (BBCNews, 2009, 10 February). In his statement on BBC News, Paul Moore said that the "real problem and cause of this crisis was that people were just too afraid to speak up and the balance and separation of powers was just far too weighted in favour of the CEO and their executive".

Corporate governance has also gained considerable attention in the Netherlands. The 2003 (updated in 2008) Dutch Corporate Governance Code identifies principles and best practices for corporate governance. The updated code emphasis a substantive approach that promotes genuine discussion within and among the different organs of a company instead of a 'box-ticking' mentality. The Dutch environment has also had its governance incidents, for example with VNU and ABN AMRO. These companies published an in control statement as part of the US Sarbanes Oxley law and the Dutch corporate governance code, but from a strategic point of view these firms turned to be out of control (Smit, 2008; Strikwerda, 2006).

## 2 The position and role of Internal Audit

The Dutch Corporate Governance Code (2008) refers to internal audit as a function for assessing and testing the internal risk management and control systems. Furthermore, the committee indicates that their plan, activities and results should be discussed with the external auditor and the audit committee.

Up to now, the internal audit profession has only indirectly been involved in the discussion in the Netherlands. No internal audit representative was included in the commission and there was no clear understanding of the role of internal audit. This understanding is growing thanks to a more active approach and through seminars (Gras, 2006). The importance of internal audit has grown from an international perspective. Internal audit is mandatory under the New York Stock Exchange corporate governance standards (NYSE, 2004). In the UK, public companies who do not have an internal audit department must provide an explanation for this (FRC, 2006).

Knowledge of the background of the existence of internal audit is important for setting the scene around the contribution or limits of internal audit in the internal control of the firm. Theoretical research on the *existence* of internal audit is limited. Adams (1994) and Paape (2007) use the agency theory to mark the internal audit department as an important monitoring body that enables management to evaluate possible information asymmetry between principal and agent. Information asymmetry is managed by monitoring actions the agents perform for the principal as well as to provide

substantiation of agents' compliance with the principals' intentions (bonding costs). Furthermore, they relate to compliance with the remuneration of the agent; internal audit can reduce the risk that a principal may take negative decisions regarding an agent's remuneration.

Furthermore, Paape (2007) links the existence of internal audit to transaction cost economics. This theory also links internal audit as a monitoring body to a decrease in information asymmetry or 'information impactedness' as it is labelled in transaction cost economics (Williamson, 1981). Transaction cost economics is generally used to explain the reason for the make or buy (insource or outsource) decision regarding outsourcing internal audit (Abbott, Parker, Peters, & Rama, 2007; J. V. Carcello, D. R. Hermanson, & Raghunandan, 2005; Rittenberg & Covaleski, 2001). It assumes that an internal audit department exists, and depending on the asset specificity, complexity and the size of the firm, the company will have an in-house internal audit department or that function will be outsourced.

A large body of applied knowledge regarding internal audit can be found at the Institute of Internal Auditors (IIA). Global professionalization of internal auditing began with the establishment of the Institute of Internal Auditors in the United States in 1941 (Brink, 1991; Courtemanche, 1991; Sawyer, 1996). This institute has published Standards for Professional Practice of Internal Auditing, which describe the objective of internal auditing. The IIA defines the field of internal audit as follows:

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

This most recent definition of internal auditing indicates a broad role and field of knowledge for the internal auditor. According to the definition stated above, the internal auditor should be involved in the complete field of control of a firm at all levels of an organization. This means attention to control at the process level, the management level and the strategic level.

Traditionally, the internal auditor has not worked at all levels of the organization. Most authors in the field of internal auditing focus on the control of a firm's operational and financial processes (Paape, 1993; Sawyer, 1996; Spira & Page, 2002). This focus is largely determined by their audit approach. Internal auditors use the cycle approach to evaluate control procedures and techniques. This approach gives consideration to objectives

(such as authorisation, compliance, accounting and safeguarding assets) and is linked to the cycles of business transactions, following transactions throughout the firms systems of control.

Another area on which internal auditors focus is the field of risk management. The definition of internal audit from the IIA describes risk management as a specific tool for accomplishing companies' objectives. Risks could be viewed as a concept used to express uncertainty about events and/or their outcomes that could have a material effect on the organization's goals (McNamee & Selim, 1998: p. 2). Attention to risk management began in the late 1990's and led to a more risk based approach with a close link to business objectives (McNamee & Selim, 1998; Spira & Page, 2002; Walker, Shenkir, & Barton, 2002). Risk management is an area in which internal audit can contribute by assisting management, the board of directors and/or the audit committee with evaluations of the entity's enterprise risk management. The external corporate governance reports demands for risk management and have offered internal auditors the opportunity to claim expertise in this crucial area (Spira & Page, 2002).

A third point of focus in the IIA definition relates to the assessment and (if necessary) improvement of an organization's governance processes. In its Standards for Professional Practice of Internal Auditing (IIA, 2004b), the IIA describes governance as "*the combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives".*

The IIA identifies a role for internal audit in promoting ethics and values within the organization, assuring effective organizational performance management and accountability, communicating risk and control information and coordinating its internal, but also external audit information to management and the board.

Although the focus for risk management, internal control and governance seems to cover the operational, tactical and strategic levels within a company, attention is not specifically devoted to the company's growth and continuity. Growth and continuity depend on the internal operation of the company as well as it dealing with its environment (Slywotzky & Drzik, 2005). Business complexity and a changing environment lead to a need for innovation, growth and adaptation of firm's organizational structures and processes (de Geus, 1997; Prahalad & Bettis, 1986; Simons, 1995). De Geus (1997) has conducted research on companies' ages and has found that only a very small percentage (0.2%) of companies still exist after a hundred

years. Thus, continuity is not a given for all companies. In addition, the growth of public companies is also important because the shareholders want to see a return on their investment.

Corporate management's primary role relates to the coordination and realisation of changes in strategy, structure and the re-allocation of resources. The changes at the corporate level affect the design of the management control framework. These management control developments should be viewed as part of internal audit's domain. Some authors already state that internal audit should perform management control audits (Geeve & Molenkamp, 1998; Paape & Korte, 2000) because management requests these types of audits. There is still no attention to strategic control.

One possible threat for internal auditors is that the rate of change of the environment, systems and processes is simply too rapid for traditional, cycle-based internal audit to work (Spira & Page, 2002). Furthermore, there is the chance that the internal auditor may not have a theoretical base as his reference. Furthermore, there is a chance that the internal auditor may not have a theoretical base as his reference.

At the end, there may be some kind of gap between the IIA's vision, its practical application and management's needs (Spira & Page, 2002). Therefore it is important to conduct research on the (formal) position of internal audit and its scope and on the subject of the audits themselves. From an academic perspective, it is interesting to sort out the background and theories surrounding internal audit functions. Paape et al (2005) indicated that there are no major established theories regarding internal auditing which raises the question regarding the status and fundamentals of statements and judgements made by internal auditors.

# 3 A Framework for internal control

The COSO framework has become the most quoted framework in discussions within corporate governance committees (Corporate Governance Committee, 2008) and regulators (PCAOB, 2004). The COSO internal control framework seems to convince auditors (internal and external), regulators, investors and society that it has the authority to achieve and to report on being in control. Recent problems with a number of firms, some of which published an in control statement based on the COSO framework, raises questions with respect to the effectiveness of the control of these firms. Furthermore, it raises questions regarding whether the COSO framework is a complete framework to achieve being in control. Does the COSO framework cover all

the elements required for being in control, or might it be that quintessential elements or aspects are missing?

The COSO framework was developed in the 1990's by the Committee of Sponsoring Organizations of the Treadway Commission, in response to discussions about an integral internal control framework (COSO, 1992). The purpose of the Committee was to formulate an unequivocal definition of internal control because internal control means different things to different people. The Treadway Commission wanted to create one common definition so that managers, legislators, auditors and others could understand one another. In the COSO report (COSO, 1992: p. 9) internal control is 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;*
- *safeguarding of assets.*

The COSO definition seems to converge internal control and management control (Vaassen, 2003), thereby enlarging the scope of internal control to encompass all levels of an organization. Management control is described as *the process by which managers influence other members of the organization to implement the organization's strategies* (Anthony, 1995; p. 8). Both definitions want to prevent or detect any deviations from defined organizational objectives (Vaassen, 2003). While internal control's unit of analysis was traditionally on transactions and the reliability of information, its point of view has now been extended to include the managerial focus on operational effectiveness and efficiency.

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

Although the Treadway Commission has defined internal control in a broad manner, it still focuses strongly on financial reporting and auditing. This is particularly apparent from the attention given to auditing terms such as reliability of the financial reporting, compliance with applicable laws and regulating and safeguarding of assets. This focus relates to the background of many COSO member organizations, which have a strong auditing or compliance objective, such as the American Institute of Certified Public Accountants (AICPA) and the Institute of Internal Auditor (IIA). Furthermore, the motivation for the COSO framework originates from the incidences of financial reporting fraud in the US. Therefore it is not surprising that the framework reflects a strong tendency towards auditing and compliance and is regarded as the standard of internal control by auditors (Renes, 2002). It seems that COSO has defined a broader definition of internal control, but has not yet managed to implement this definition in all its broadness within its own framework.

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

Both COSO frameworks have included principles or criteria which can lead to a statement regarding operational effectiveness and efficiency. Nevertheless, the question is whether COSO and its criteria are specific enough and whether it is complete? First of all, there is not sufficient theoretical basis for the COSO framework to provide an appropriate answer to the previous question. Secondly, in reviewing older literature on auditing it is actually peculiar that the specification of the COSO framework focuses primarily on internal accounting controls and the organization's accounting discipline. Around 1961, Mautz and Sharaf (1961/1985) already identified that auditing is an applied discipline, which means that it takes its principles from other fields. They noted that the fields of knowledge that influence auditing include accounting, law, ethics, management, communications and others (Mautz & Winjum, 1981).

In the following chapters, an initial exploration of underlying theories is discussed along with some missing principles that are not part of the current COSO framework(s).

# 4 A closer look at a theoretical foundation

From the academic field of economics, the theory of the firm provides a theoretical basis for being in control. The most influential article regarding the nature of the firm is from Coase (Coase, 1937). His article reflects a change in economic thinking from being concerned with price theory and the effect of markets on firm behaviour, to being concerned with the firm itself. He describes the major elements of modern theory of the firm (Coase, 1937; Foss, 1999). First of all, he describes why a firm exists. Firms exist because they are less costly than continuous exchange on the market. Secondly, he addresses the cost of using the price mechanism (transaction costs); thirdly, he mentions the importance of studying the forces that determine a firm's size (and/or the boundaries of the firm). Finally, he highlights the role and importance of a firm's internal organization.

The existence, the boundaries and the internal organization of the firm are the key elements of theory of the firm (Foss, 1999). This Coasian view of the firm is used as the basis for this paper rather than neoclassical theory of the firm, in which the firm is considered to be a black box production function.

The theory of the firm is far from homogenous and involves different views. One common element in the theory of the firm can be found in (different departures from) the Arrow-Debreu (perfect competition /general welfare theorem) model (Foss, 1999: p. xxviii). First of all, this model assumes complete contracting which can be written without costs. The second assumption is symmetry of information which leads to a complete view of all relevant information.

The incomplete contract theories (such as transaction cost economics) break with the first assumption and comply with the second assumption. Their assumption is that it is costly to draft complex contracts. Therefore *ex post* governance is required to remain in control. The complete contracting theories (such as the agency theory) comply with the first assumption and break with the second assumption of the Arrow-Debreu model regarding information symmetry. They assume complete contracts characterized by *ex ante* incentive alignment, but they also assume the presence of asymmetric information and risk preferences.

The complete and incomplete contract theories of the firm generally have three important streams[1]; transaction cost economics, agency theory and property right theory (Foss, 1999; Furubotn & Richter, 2000; Williamson, 1996).

Williamson incorporated the Coasian view in his transaction cost economics. Williamson describes the firm as a governance structure (an organizational construction) rather than a production function (a technological construct) (Williamson, 1996). The firm is not a black box as in neoclassical economics, but an organizational construct in different modes– hierarchies, market, hybrids, and bureaus. The construct depends on the concept of transaction costs. This change in approach made it possible for economics to analyse the internal organization of a firm. In the neoclassical view there are no incentive and coordination issues because of perfect market contracting (Foss, 1999).

Williamson integrated key assumptions of the behavioural theory of the firm from Cyert and March into his theory (Cyert & March, 1992). The first assumption relates to bounded rationality (Simon, 1976/1945), the notion that decision makers' capabilities are bounded in terms of formulating and solving problems and processing all information during the decision process. The second assumption deals with opportunism, e.g. possible conflicts because individuals are promoting their own self-interest. Furthermore, Cyert and March conceived the firm as a system of rules that change over time in response to experience. These experiences are translated within the organization through learning about performance in relation to its aspirations and its multiple, conflicting goals (Augier & March, 2008). The ideas form the behavioural theory of the firm are also translated into strategic theories of firms[2] (Augier & March, 2008; Winter, 1988).

[1] In addition to the agency, property rights and transaction cost economics Foss (1999) also highlights some new, uncommon perspectives on the theory of the firm, like the coordination perspective. This coordination perspective focuses primarily on the employment relationship and has a close link to agency theory and property rights theory. For this reason, this will not be discussed separately in this thesis. The same applies to the Information processing view, which concentrates on team theory work. The latter can be viewed as part of transaction cost theory.

[2] The resource / knowledge based view is one of the strategic theories of the firm, which used ideas form the behavioural theory of the firm regarding competitive interaction and performance of firms/

Like the transaction cost theory, property rights theory assumes the view that contracts are incomplete. Contracts are incomplete in the sense that they contain gaps or missing provisions (Hart, 1989), which are accepted by both contract parties. This results in a focus on assets, i.e. ownership (Hart, 1989). Hart argues that ownership is a bundle of decision rights and is linked to residual rights of control (Grossman & Hart, 1986). This theory explains the boundaries of a firm, e.g. describing both the costs and the benefits of the integration of firms.

One difference between this and the transaction cost economics view relates to the assumption of maximizing behaviour instead of bounded rationality. Maximizing behaviour assumes that people are self-interested, e.g. people will not act in the interest of others to the exclusion of their own preferences (Jensen, 2000: p. 5).

The agency theory shares the assumption of maximizing behaviour. Moreover, Jensen points out that the property right approach is quite complementary to the agency view (Jensen & Meckling, 1976). Both concentrate on the property rights specified in contracts.

Jensen and Meckling (1976: p. 311) define the firm as a legal fiction that serves as a nexus for contracting relationships among individuals and is also characterized by the existence of divisible residual claims on the organization's assets and cash flows which can generally be sold without the permission of the other contracting individuals. This definition emphasizes the importance of the contractual nature of a firm. Contractual relations not only relates to the employer and the employees, but also contracts with suppliers, customers, creditors, etc. Jensens' nexus of contract does not provide an answer on the question of why a firm exists; it focuses on (the lack of) the boundaries of a firm and on its internal organization.

*Criticism and new fields in the theory of the firm*

There have been criticisms of the main driver of the modern theory of the firm – transaction cost economics. The main criticism is that transaction cost economics devotes too little attention to running a business, while focussing excessively on asset specificity and opportunism (Foss, 1999). Moreover, Milgrom and Roberts criticize the predominance of incentive-based transaction cost economics in the theory of the firm; they would like to see competing and complementary theories emerge in the field of the production process and more specifically on adaptation and planning (Milgrom & Roberts, 1988) and different production costs for tasks across firms (Demsetz, 1988).

Other attention points are the lack of attention to path dependency and the effects of interactions among transactions and/or the firm's capabilities (Foss, 1999; Winter, 1988). Another criticism is that too little attention is devoted to a firm's strategy and dynamics, such as organizational learning and innovation (Foss, 1999; Williamson, 1999).

There is also criticism regarding the agency theory with respect to partial research into governance mechanisms independently, rather than considering the whole. As a consequence, the agency theory only provides a partial view of organizations (Eisenhardt, 1989). Furthermore, the theory overlooks the more fundamental question of what the principal should want the agent to do (Foss & Klein, 2004: p. 2).

Foss advances the Resource / Knowledge based view as a set of complementary thoughts for the theory of the firm (Foss, 1999). The resource / knowledge-based view devotes attention to the importance of adaptation, technology and innovation and learning. These dimensions are complementary to current view of the firm.

Below is the overview, including concepts and assumptions with the Coasian theories of the firm and including the resource / knowledge-based view (Foss, 1999: p xxx; Jensen, 2000; Williamson, 1996).

| | **Agency theory** | **Transaction Cost Economics** | **Property Rights theory** | **Resource / Knowledge-based view** |
|---|---|---|---|---|
| **Concept of the firm** | A legal fiction | A collection of residual decision rights to physical assets | A collection of residual decision rights to physical assets | A bundle of knowledge assets |
| **Rationality** | Maximizing | Bounded | Maximizing | Bounded |
| **Contracting** | Complete | Incomplete | Incomplete | Incomplete |
| **Transaction costs** | Monitoring and bonding costs | Costs of drafting complex contracts | Costs of drafting complex contracts | Costs of integrating knowledge in firms and transmitting knowledge across the boundaries of firms |

| **Unit of analysis** | Contracts | Transactions | Transactions | Resources or combination of resources |
|---|---|---|---|---|

*Recent developments around the theory of the firm*

The control of the firm is not static. Current literature shows insights that the nature of firms, as expressed in the concept of the modern business firm, which implicitly is assumed in e.g. COSO, is changing (Rajan & Zingales, 1998; Zingales, 2000). The traditional view regarding control of the modern business firm is based on vertically integrated firms with clear boundaries defined by its physical assets. Most of the transactions involved in the production process took place within the firm. The few transactions that took place between the firm and the outside were largely at arm's length (as between the firm and the final consumer). The legal boundaries of the corporation could be drawn around these assets and also coincided with its economic boundaries (Rajan & Zingales, 1998: p. 12).

Authors like Chandler (1990) and Sloan (1990) provide insight into large integrated production-related firms whose physical assets are their critical resource. Furthermore, the legal claims over these (in)tangible assets were the most important source of power. Coordination was performed through organizational hierarchies, where top management communicated with lower management through intermediate managers in the hierarchy. This command-and-control system gave top management considerable power and control over the firm's assets and surplus. As firms grew, the need arose for outside investors to finance assets and to bear the risk associated with large ownership stakes. The concentration of power at the top of the organizational pyramid, together with the separation between ownership and control, transformed the agency problem between top managers and shareholders into the primary corporate governance problem (Rajan & Zingales, 1998: p. 15).

According to Rajan and Zingales (1998) the nature of the modern business firm has changed. As part of globalization, markets become more open. Globalization led to the break up of integrated (US) firms which had to compete with firms that are organized differently. This break-up of companies changed the boundaries of the economic organization, creating more mutually dependant firms. This leads to the creation of new forms for the governance of transactions and the governance of the firm's residual claim.

Furthermore, competition has increased the importance of human capital as a scarce resource relative to tangible assets. Human capital is needed to create innovative products, services and processes. People's knowledge and skills can not be easily appropriated by a company. Rajan and Zingales (1998) argue for devoting more attention to new mechanisms for controlling and retaining human capital.

# 5 Linkages between the theory of the firm and COSO

The theory of the firm shows a broad field of streams which provide input on the existence, the boundaries and the internal organization of the firm. As mentioned earlier, it is not yet a homogeneous theory. However, the different streams can also provide a theoretical basis for the field of internal audit. Therefore, an initial link is made between the theory of the firm and the COSO framework. The following streams are linked to COSO:

- Transaction cost economics
- Property rights theory
- Agency theory
- Resource / knowledge based view of the firm

*Transaction cost economics (including property rights theory)*

Transaction cost economics provides a basis for describing a contractual or transactional relationship between parties for which each party expects something from the other (Speklé, 2001). This can be a relationship within the organization, but also between organizations. Transaction costs can be governed by three governance mechanisms: market, hierarchy or hybrid (Williamson, 1981).The choice of mechanism depends on a comparative analysis of the transaction costs characteristics ((i.e. asset specificity, uncertainty and frequency) of these alternatives. Transaction costs are the costs related to writing, monitoring, enforcing and adapting contracts.

COSO refers to relationships with external parties as part of a firm's integrity and its stakeholders. In contrast to transaction costs economics, it does not cover the make or buy decision of insourcing or outsourcing activities, i.e. choosing governance through market, hybrid or hierarchy. Transaction cost economics assumes that higher asset specificity leads to hierarchy as a governance mechanism to protect the transaction against opportunistic behaviour. Alternatively, activities of low asset specificity are expected to be governed by the market mechanism (Williamson, 1996). The boundaries of the firm are always a point of attention, especially due to the concentration

on core capabilities and restructuring of non-core capabilities, joint ventures, outsourcing, buyer-supplier arrangements, etc (Dekker, 2004; Speklé, 2001; van der Meer-Kooistra & Vosselman, 2000). Transaction cost economics can provide a theoretical basis for analyzing these types of modes.

*Agency theory*

The background of auditing lies in verifying that the accounting operations of the organization are performed correctly (Courtemanche, 1991) or in a broader sense with evaluating evidence about information in order to determine and report on how well this information complies with established criteria (Arens & Loebbecke, 2000).

There is also a strong link with the COSO framework regarding governance mechanisms such as monitoring by the board, board committees, and the remuneration-incentive process. Researchers have identified governance mechanisms[3] that limit agents' self serving behaviour and goal congruence (Eisenhardt, 1989; Jensen & Meckling, 1976; Kosnik, 1987). The emphasis continues to be on the ability of principals to reduce information asymmetry by installing appropriate information systems within the firm to provide information regarding the behaviour of the agent and the outcomes of his work (Eisenhardt, 1989).

The board of directors is an important mechanism. This body monitors managerial actions on behalf of the shareholders. In the last few decades, the governing role of boards has evolved to include new board conditions and procedures that should promote the board's effectiveness in monitoring management on behalf of stockholders (Kosnik, 1987).

A board's compensation / remuneration committee can be an effective deterrent for focussing on short-term rather than long-term value, especially when this committee can influence the remuneration process, policies, and practices (Jensen & Murphy, 2004). In current high equity-based compensation schemes, boards must monitor the remuneration process to prevent managers from benefiting from short-term increases in stock prices

[3] Although external forces have an indirect impact on the internal governance mechanisms, the focus is on internal control, which means that other mechanisms of governance are not discussed. This means that external control mechanisms, such as external regulatory oversight, capital markets and takeover possibilities, market competition and the managerial labour market are not discussed (Jensen, M. C. 1993. The modern industrial revolution, exit, and the failure of internal control systems. Journal of Finance, 48(July): 831-880.

that are achieved at the expense of long-term value. Jensen and Murphy emphasize the 'importance of being involved in the process and not only 'bless' plans which have been approved by top management. This can create an environment that invites abuse and bias' (Jensen & Murphy, 2004: p. 51)

Proper control of the incentive programs is one of the Board's important roles, along with concrete criteria, the use of objective standards for target setting, linking performance to set targets and use of a mixed cash-stock-stock options structure (Knight, 2002).

Ultimately, agency theory provides insights into how to deal with relationships (principal-agent) and underlying assumptions of self-interest, bounded rationality, risk adversity and mechanisms so as to control these assumptions and risks. Agency theory does not (fully) explain mechanisms such as ethics, organizational structure, the allocation of decision rights, planning and reporting, management style and leadership; however, these are important elements for being in control and part of the COSO framework.

Furthermore, agency theory does not include the elements of a changing environment, competitive realities and the necessity to refocus resources within a firm in order to survive and grow. These subjects are important in controlling a firm and are covered in the theory below – the resource-based view.

*Resource-based view*

The COSO report refers explicitly to Michael Porter's 'Competitive Advantage'. In his work, Porter (1985) describes the link between strategy and sustained competitive advantage. However, Porter's analysis focuses primarily on the external environment and does not integrate internal environment mechanisms, which produce a competitive advantage (Barney, 1995). Internal attributes are also those which provide a firm with a competitive advantage, despite the possible unattractive, high risk and low opportunity environment within which these firms operate. This interest in internal attributes is part of the resource-based view. It focuses on a firm's competitive position in relation to the firm's unique resources and relationships (Barney, 1991; Conner, 1991).

The resource-based view shows some missing links in the COSO framework with respect to the domain of strategy and focus on resources and capabilities. This element is included in the COSO ERM framework, but it

does not describe the essential elements surrounding strategy as described in the resource-based view. The added value of the resource-based view compared to the COSO framework is the business point of view, since it describes the key elements for a profitable firm.

Some important mechanisms that can be added to the COSO framework include (Barney, 1986; Conner, 1991; Mahoney, 1992; Prahalad & Hamel, 1990; Rumelt, 1997):

- Analysis of the firm's identification, organisation and exploitation of valuable, rare, difficult to imitate resources – or core competences – or capabilities. Physical resources, but also intangible resources such as skills, culture, reputation;
- Analysis of a firm's attention to reputation and consumer trust;
- Management's analysis of the balance between exploitation and exploration as part of continuous innovation;
- Attention to unique managerial talent – leadership;
- Attention to learning by and adaptability of the organization;
- Importance of superior information regarding costs, profits and responsibilities, etc.;
- Safeguarding intellectual property through regulation, patents, trademarks, etc.

The preceding list is not mutually exclusive because resource-based view theorists have argued persuasively that competitive advantage results from superior knowledge, or luck, or a combination of the two (Barney, 1986; Diericks & Cool, 1989).

However, the resource-based view does not directly answer the question regarding when a firm is in control. Implementation of the identified mechanism differs per firm. This is in line with the resource-based view's assumption regarding heterogeneity. Furthermore, the resource-based view does not include clear criteria for being in control. The mechanisms remain on an abstract level, as a result of which they are difficult to apply. The hope is that more concrete criteria will be found in the management literature.

# 6 Exploration of principles of control

Various scholars have been interested in control principles for some time now. A broader and historically extensive field of research and knowledge regarding control of the firm is in place which deals with control of a firm's internal and external environment (see also Strikwerda (2005)). The following table incorporates an initial exploration of possible principles of control. However, more detailed research is required to complete the multidisciplinary view of being in control.

| View | Major assumptions | Key authors |
|---|---|---|
| Management control view | Management control is viewed as top management's task; management must establish a link between strategic planning and operational control. The controls should increase the probability that the objectives can be achieved.<br><br>In addition to formal arrangements regarding budgeting and reporting, its scope has evolved and now includes behavioural controls, as well. | (Anthony, 1995); (Merchant, 1998; Simons, 1995) |
| Management view | Management deals with planning, organizing, leadership, coordination and controlling. It deals with principles such as managing objectives, delegation of authorities, structure, etc., which can lead to an efficient and effective organization. | (Drucker, 1974; Fayol, 1916; Mintzberg, 1973) |
| Psychological view | Appropriate psychological checks and balances and attention to psychological factors such as cognitive biases (e.g. anchoring, competitor neglect), reinforcement of unrealistic views. belief conservatism, dominant logic, narcissism, etc., which leads to a board being in or out of control | (Kets de Vries, 2001; Lovallo & Kahneman, 2005; March, 1994; Prahalad & Bettis, 1986) |
| Organizational Culture view | Culture consists of basic assumptions, values and beliefs and artefacts that provides direction for people. It is important that management influence and control people in both thinking and acting. Leading by example and vision are important tools management uses to create the appropriate culture | (O'Toole, 1995; Schein, 1992) |

| | | |
|---|---|---|
| Organizational learning | For effective control there should be awareness and consistency between the espoused theory and theory-in-use. The espoused theory is what we say we do or would like to do, while the theory-in-use shows the real behaviour. | (Argyris, 1999) |
| Organizational Politics view | Within organizations power is used to acquire, develop and use influence and resources to obtain preferred results in situations involving uncertainty. To be in control means being aware of the level of politics, its rightful application and preventing conflicts among individuals or groups that can hinder the achievement of the firms goals. | (Mintzberg, 1983; Pfeffer, 1992) |
| Resource dependence view | A firm is in control when it succeeds to acquire those resources as needed for its continuity in the long term. | (Pfeffer & Salancik, 1978) |
| Systems view | Companies need to be sufficiently adaptable to cope with a changing environment. Ashby's Law and his Law of Requisite Variety concerns with variety in the control system. Through the use of information and feedback within its system, it should be flexible and able to deal with fluctuations of its environment. | (Ashby, 1956) |

**Table 1: Different points of view regarding control**

Proper analysis and utilization of existing alternative views regarding control will provide insights into criteria and principles for assessing the effectiveness and efficiency of operations and the effectiveness of the firm as a whole. As demonstrated above, on the one hand there are controls related to the most efficient and effective organizations of resources within and outside a firm. On the other hand, there are controls related to controlling the hearts and minds of the organization's people (Rollinson, 2005). These alternative views differ considerably from the perspective of the current corporate governance codes and COSO. It is important to further study a view that also includes the language and opinion of control from business executives and management.

The development of principles of (internal) control, in particular controls at the strategic and management level, is not an easy task that can be performed in a brief time period (Paape, 1999). Additional research will be

performed to take it one step ahead, based on the current knowledge from different fields of knowledge.

# 7 Conclusions and further research

There is an interrelation between the current corporate governance reports, the question regarding control of the firm and internal audit's position in this spectrum. Over the last decade, the field of internal auditing has been strongly affected by influences from organizational and corporate governance developments (Lemon & Tatum, 2003).

In order to answer the question regarding what the contributions and limits of the internal auditor can and or should be with respect to the issue of being in control, we need to acknowledge that the COSO approach of being in control is too limited and does not cover all dimensions of being in control in terms of scope and mechanisms.

Second, we need to acknowledge that the internal auditing profession needs a proper theoretical foundation to gain an understanding of both its contributions to and limits regarding control of the firm.

In this paper an initial exploration of a theoretical foundation is made by looking at the theory of the firm as a meta theory for analysing internal control of a firm. The theory of the firm is far from homogenous and involves different views, but these different views (agency, transaction costs, and resource based view) provide different dimensions / issues which can be complementary to each other and to the internal auditor by analysing control issues within a firm.

Moreover, an initial exploration of research with alternative views on control has been identified to complete missing elements in COSO. The different points of view show clear opportunities to create a more comprehensive view on being in control.

The next step is to extend the theoretical foundation and principles through more detailed literature research. In addition, the results will have to be confronted with the current practice and needs within firms by discussing these topics with subject matter experts, such as heads of internal audit departments, IIA research members, a member of the COSO Committee, member of the Dutch Corporate Governance Committee. Furthermore, the extended view on being in control will be investigated through case studies with AEX/Midkap companies. Through these empirical discussions a first step towards validation can take place.

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