



**FACULTY OF ECONOMICS AND BUSINESS ADMINISTRATION**  
**DEPARTMENT OF ACCOUNTANCY AND CORPORATE FINANCE**

**THE ROLE OF INTERNAL AUDITING IN CORPORATE GOVERNANCE:  
QUALITATIVE AND QUANTITATIVE INSIGHTS ON THE INFLUENCE OF  
ORGANISATIONAL CHARACTERISTICS**

Dissertation

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by

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*To Els*

*“If you can see it, and believe it, you can achieve it”*

Marcus Aurelius



## **DOCTORAL JURY**

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## **KORTE VOORSTELLING VAN HET PROEFSCHRIFT (in Dutch)**

De welbekende bedrijfsschandalen die de ondernemingswereld het afgelopen decennium op zijn grondvesten deed daveren, hebben ertoe geleid dat risicobeheersing en interne controle een steeds belangrijker onderdeel werden van corporate governance (zogenaamd ‘deugdelijk bestuur’). Diverse nationale en internationale regelgevingen en richtlijnen stimuleren de raad van bestuur en het management om op een solide manier ondernemingsrisico’s te beheersen en openlijk te tonen dat ze hun onderneming onder controle hebben. Meer specifiek dient de raad van bestuur erop toe te zien dat risicobeheersystemen en interne controles aanwezig zijn in de onderneming, een verantwoordelijkheid die vaak gedelegeerd wordt naar het auditcomité. Het management is op zijn beurt verantwoordelijk voor het identificeren en evalueren van de ondernemingsrisico’s gevolgd door het opzetten, implementeren en bewaken van een degelijk interne controlesysteem.

Door duidelijk te benadrukken dat interne audit dient bij te dragen tot de evaluatie en verbetering van de risicobeheersing, de interne controles en het beheer van de onderneming, erkent het Instituut voor Interne Auditoren (IIA) de rol van interne audit in corporate governance. Interne audit is dé functie bij uitstek om de raad van bestuur, het auditcomité en het management te ondersteunen bij het deugdelijk besturen van de onderneming. Dit geeft interne audit de mogelijkheid om zijn toegevoegde waarde voor de onderneming te tonen alsook om zich los te maken van het aloude imago van politiemans en waakhond. Met andere woorden, kennis en ervaring met betrekking tot risicobeheersing en interne controle worden een belangrijke troef voor interne audit om zijn rol in corporate governance te verstevigen.

Dit proefschrift behandelt twee grote onderzoeksvragen. In eerste instantie wordt de grootte van de interne audit verklaard. In tweede instantie wordt dieper ingegaan op organisatievariabelen die een invloed hebben op de interne auditactiviteiten. Dit proefschrift bestaat uit zes gerelateerde papers die samen een zo volledig mogelijk beeld van het interne auditberoep in een niet-Angelsaksische context trachten te schetsen. Het combineren van diverse theoretische invalshoeken leidde tot vernieuwende inzichten die bijdragen tot zowel de academische literatuur als de ontwikkeling van het interne auditberoep. Dit proefschrift is gebaseerd op een weloverwogen combinatie van kwalitatieve en kwantitatieve empirische data. Agency theorie toont aan dat interne audit een belangrijk toezichtsmechanisme is voor het reduceren van zowel interne als externe informatieasymmetrie. Complementair aan de agency

theorie worden in dit proefschrift alternatieve verklaringen, gebaseerd op kenmerken van de controleomgeving, ontwikkeld en getest voor de grootte van de interne audit. Het is dan ook een uitdaging voor verder onderzoek in dit domein om deze nieuwe theoretische benadering te verfijnen. Naast het verklaren van de grootte van de interne audit worden in dit proefschrift organisatievariabelen bestudeerd die de interne auditactiviteiten beïnvloeden. Interne auditactiviteiten dienen bestudeerd te worden vanuit de interactie tussen interne audit en zijn belanghebbenden, zijnde het auditcomité en senior management. Deze interactie wordt gekenmerkt door het zoeken naar comfort door de belanghebbenden en het creëren van comfort door interne audit, meer specifiek in het domein van risicobeheersing en interne controle. De nood aan comfort alsook de manier waarop interne audit comfort biedt, wordt in belangrijke mate beïnvloed door de corporate governance context en de status van het risicobeheersysteem en de interne controles. Het wordt duidelijk in dit proefschrift dat de belanghebbenden van interne audit dit comfort belonen door het geven van de nodige ondersteuning die cruciaal is voor de aanvaarding en verdere uitbouw van de interne auditfunctie.

Naast de academische bijdrage tracht dit proefschrift ook een bijdrage te leveren tot het interne auditberoep. Het dient benadrukt te worden dat dit proefschrift enkel tot stand kon komen door intensieve samenwerking met deze beroepsmensen. De inzichten uit dit proefschrift bieden hen een leidraad om hun positie in de hedendaagse bedrijfswereld te versterken.





## **INTRODUCTION**





**The Role of Internal Auditing in Corporate Governance:  
Qualitative and Quantitative Insights on the Influence of Organisational Characteristics**

**INTRODUCTION**

The increased regulatory demands for accountability, following the well-known corporate scandals that have shaken the worldwide business environment in the last decade, have brought organisations' risk management and internal control systems into the public policy debates on corporate governance. Many national and international corporate governance regulations and guidelines, including recent initiatives taken by the European Commission (2003) and the Belgian Corporate Governance Committee (2004), clearly demand that boards of directors and executive management adhere to sound risk management, and demonstrate publicly that they are in control of their organisations. More specifically, the board of directors is responsible for ensuring that appropriate systems of risk management and internal control are in place. In addition, an audit committee is often established to assist in carrying out these growing monitoring responsibilities with respect to control in the broadest sense. Subsequently, it is the role of executive management first, to identify and evaluate the risks faced by the company, and second, to design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.

By stating that internal auditing should evaluate and contribute to the improvement of risk management, control and governance, the Institute of Internal Auditors (IIA) formally recognises the assurance and consulting role of internal auditing in corporate governance, and thereby, reflects existing practice:

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

An internal audit function that meets this definition is uniquely positioned to support the board, the audit committee, and executive management as an essential component of their governance mechanisms (ECIIA, 2005). Consequently, a significant opportunity for internal auditing has emerged to demonstrate its potential to add value and to break away from its

historical characterisation as “organizational policeman and watchdog” (Morgan, 1979). In other words, expertise and knowledge of risk management and internal control become a source of power for internal auditing to advance and play an important assurance and advisory role within the contemporary corporate governance environment.

In this dissertation, I deal with two major research questions. First, I explain the size of the internal audit function from two different theoretical viewpoints. Second, I go deeper into the organisational variables influencing internal audit practices. Internal auditing has moved towards a hybrid and pro-active function that has to meet modern companies’ dual need for assurance and value-added suggestions on governance improvement. Although extensive practitioner literature on internal auditing exists, the academic literature in this area remained rather limited until a few years ago (Kalbers and Fogarty, 1995; Vinten, 1996). Since then, the number of studies published in international journals has increased significantly, illustrating the growing academic interest in this still unexplored research area.

This dissertation consists of six related papers, together aiming to provide a comprehensive picture of the internal auditing profession. This dissertation includes insights on the internal audit function (macro level) as well as insights on internal audit practices and interactions with organisational parties (micro level). Throughout this dissertation, several research methods are applied. Four papers are based on qualitative data stemming from theory specification case studies, enabling to obtain deeper insights on internal audit practices and the interaction with organisational parties. In other words, existing theories or findings were taken into the field to assess whether they capture the heterogeneity and complexity of contemporary internal auditing practices. It was kept in mind that core concepts and relationships may need to be re-conceptualised, refined or elaborated in order to come up with more specific and structured conclusions (Keating, 1995). Two papers are based on quantitative data resulting from a questionnaire administered to Chief Audit Executives in Belgium and the annual reports of their respective companies. These quantitative data enable to validate insights obtained from the qualitative data. This mixed research method fits within the intention to come up with a comprehensive picture of internal auditing and provides a basis for sound and well-founded conclusions. Appendix 1 gives an overview of the subject and the research method of all six papers. Appendix 2 provides background information on the 18 case studies, conducted in 2004 and 2005.

The first paper explains the size of internal audit functions within Belgian companies using an agency model. Data to test this model were collected from annual reports and a questionnaire sent to Chief Audit Executives. The results show that the agency model has high explanatory power and reveal that the more diffused the ownership structure of the company, the larger the company and the more reporting levels within the company, the larger the internal audit function. The results of this study confirm the growing role of internal auditing in monitoring corporate governance.

The second paper identifies three organisational characteristics that influence internal audit practices and specifies how each of them can exert that influence. This study is based on a literature review, combined with insights from six theory specification case studies. The results indicate that internal audit practices are influenced by the stakeholders of internal audit, the organisational support for internal auditing and the risk management and internal control system.

The third paper goes into more detail on the role of internal auditing in risk management, including internal control. The paper describes and compares in a qualitative way how internal auditors within U.S. and Belgian companies perceive their role in risk management. In order to obtain adequate data, ten theory specification case studies were conducted. The findings illustrate that in the Belgian cases, internal auditors' focus on acute shortcomings in the risk management system creates opportunities to demonstrate their value. Internal auditors are pioneering the creation of a higher level of risk and control awareness and a more formalised risk management system. In the U.S. cases, internal auditors' objective evaluations and opinions are a valuable input for the new internal control review and disclosure requirements stipulated by the Sarbanes-Oxley Act.

The fourth paper, building upon the sociology of professions literature, investigates the extent to which audit committees are uncomfortable with risk management and internal control, and how internal audit can be the expert in providing comfort in these areas. Four theory specification case studies reveal that audit committees need comfort with respect to the control environment and the internal controls in high-risk areas. Thanks to their internal position, their familiarity with the company, and their proximity to people across the company, internal audit seems to be the most suitable mean of providing comfort and becoming the 'guard of the corporate culture'. Besides internal audit's assurance role, active

involvement in the improvement of these internal controls brings a significant level of comfort to the audit committee. Their unique conceptual and company-specific knowledge of risk management and internal control, combined with the right inter-personal skills, enables internal audit to provide this comfort. Formal audit reports and presentations, together with informal contacts, seem to be important ways of providing this comfort.

The fifth paper, based upon five theory specification case studies, offers a qualitative assessment of the relationship between internal audit and senior management, analysing the expectations and perceptions of both parties. It was found that senior management's expectations have a significant influence on internal audit, and that internal audit, generally, is able to meet these expectations. Senior management wants internal audit to compensate for the loss of control resulting from organisational complexity. On the one hand, senior management expects internal audit to play a supporting role in the monitoring and improvement of risk management and internal control, and wants them to monitor the corporate culture. On the other hand, internal audit expects senior management to take the first steps in the formalisation of the risk management system. They are also looking for senior management support, as this benefits their overall acceptance.

The sixth paper contributes to the literature by developing three control environment variables, reflecting the contemporary context in which internal auditing is operating, and testing how these variables are related to the size of the internal audit function. Data were collected from a questionnaire sent to Chief Audit Executives. The new control environment variables turned out to be relevant when studying the size of the internal audit function. The results show that the degree of formalisation of the risk management system and the risk culture are both positively associated with the size of the internal audit function. Furthermore, the significance of the control environment variables seems to differ between the smallest and largest companies. The results of this study lead to a conceptual model for further research.

Appendix 3 gives an overview of the key constructs discussed in this dissertation.

This dissertation positions the internal audit function within the contemporary corporate governance context. More specifically, each paper illustrates how current corporate governance requirements have an impact on the internal audit profession. Besides, this

dissertation complements previous research, mainly conducted in Anglo-Saxon countries, by studying internal auditing within a continental European context where corporate governance requirements are less stringent and where, for a majority of companies, the establishment of an internal audit function still remains voluntary.

In addition to validating the traditional agency model, this dissertation presents other organisational variables that have a significant influence on the size of the internal audit function and/or the internal audit practices. After the identification of these organisational variables in paper two, the subsequent papers provide a deeper analysis of the influence of these variables, thereby enhancing the understanding of contemporary internal auditing practices. Using qualitative data gives us a more profound insight into the specific roles of internal auditing in risk management and internal control as well as the influence of particular organisational variables.

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**PAPER 1**  
**THE AGENCY MODEL AS A PREDICTOR OF**  
**THE SIZE OF THE INTERNAL AUDIT FUNCTION IN BELGIAN COMPANIES**

The first paper, explaining the size of the internal audit function (macro level), provides an answer to the first research question of this dissertation. This paper illustrates the growing monitoring role of internal auditing in reducing principal/agent problems resulting from the separation of ownership and control of companies, and therefore illustrates the relevance of studying the role of internal auditing in contemporary corporate governance. Furthermore, this paper demonstrates the role of internal auditing in reducing internal principal/agent problems between top management and lower management, a topic that will be investigated in more detail, using theory specification case studies, in paper five of this dissertation.



# THE AGENCY MODEL AS A PREDICTOR OF THE SIZE OF THE INTERNAL AUDIT FUNCTION IN BELGIAN COMPANIES<sup>1</sup>

Gerrit Sarens

**Abstract:** This study attempts to contribute to the literature by explaining the size of internal audit functions in a non-Anglo-Saxon environment using an agency model. Data to test this model were collected from annual reports and a questionnaire sent to Chief Audit Executives. The results show that the agency model has high explanatory power and reveal that the more diffused the ownership structure of the company, the larger the company and the more reporting levels within the company, the larger the internal audit function. The results of this study confirm the growing monitoring role of internal auditing in contemporary corporate governance.

**Keywords:** internal auditing, Belgium, agency theory, questionnaire, annual report.

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## INTRODUCTION

Despite all of the recent attention focused on the internal audit function as one of the crucial parties within corporate governance (Carcello et al., 2005b), little is known about the factors explaining the size of the internal audit function. Why do some companies have a large internal audit function, while others do not? This is especially relevant in continental Europe, where internal auditing is still a relatively young profession and where corporate governance requirements are less stringent than they are in the Anglo-Saxon world (Sarens and De Beelde, 2006a). Therefore, this study attempts to explain the size of the internal audit function within Belgian companies. Following Willekens et al. (2004), it can be argued that Belgium is representative of a non-Anglo-Saxon environment. At the time of this study, Belgian companies, with the exception of those listed on the New York Stock Exchange (NYSE) as well as banks and insurance companies, were not mandated to install an internal auditing function.

The literature is replete with studies that have used agency theory to examine the role of external auditing (e.g. DeAngelo, 1981, Watts and Zimmerman, 1983). The provision of audited financial statements has been confirmed to be a cost-effective contractual response to agency costs. Similarly, internal auditing may also serve as a monitoring response to agency costs (Anderson et al., 1993; DeFond, 1992). Relatively few studies have used agency theory to explain the importance of internal auditing (Adams, 1994). Given the insights from the studies indicating the relevance of agency variables in explaining monitoring through auditing, this study adopts a traditional agency model to explain the size of the internal audit function in a continental European environment. Few studies have investigated voluntary demand for internal auditing (Anderson et al., 1993; Carey et al., 2000; Wallace and Kreutzfeldt, 1991) and the present study accordingly adds to this literature. From a practical point of view, companies can use the model tested in this study to decide on the size of their internal audit function, a question that is highly relevant in today's business environment (Carcello et al., 2005b). The results of this study confirm the explanatory power of agency variables such as diffusion of ownership, company size and the number of reporting levels.

The following section of this paper develops hypotheses for the agency model based on a review of the relevant literature. The third section outlines the methodology of this study. The fourth section shows the empirical results. The paper ends with a summary and discussion of the conclusions.

## **LITERATURE REVIEW AND DEVELOPMENT OF HYPOTHESES**

Agency theory postulates that a company consists of a nexus of contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling those resources (Jensen and Meckling, 1976). Agency theory is based on the idea that agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor whether or not their interests are being properly served by agents. It also assumes that principals and agents act rationally and that they will use the contracting process to maximise their wealth. This means that because agents have self-seeking motives, they are likely to take the opportunity to act against the interests of the owners of the company. Jensen and Meckling (1976) refer to this dilemma as the moral hazard problem. Another type of agency problem is adverse selection. This occurs when the principal does not have access to all available information at the time a decision is made by an agent, and is thus unable to determine whether the agent's actions are in the best interests of the firm. To ensure the so-called pareto-optimality in the contracting process, both principals and agents will incur contracting costs.

Sherer and Kent (1983) and Watts (1988) suggest that internal auditing is a bonding cost borne by agents to satisfy the principals' demands for accountability. The cost of internal auditing can also be judged to be a monitoring cost which is incurred by principals to protect their economic interests. Agency theory contends that internal auditing, like other intervention mechanisms like financial reporting and external auditing, helps to maintain cost-efficient contracting between owners and managers. Adams (1994) illustrates that agency theory helps to explain the existence of internal auditing in companies but can also help to explain an important characteristic of the internal audit function, namely its size. It is assumed that the more information asymmetry, the greater the need for monitoring to reduce this information asymmetry, resulting in a larger internal audit function. In a larger internal audit function, there will be more staff, representing a more diverse range of skills and competences, that will be able to reduce a greater range of information asymmetry problems.

Furthermore, the scope of the internal audit work covered would be greater in a larger function than in a smaller function (Mat Zain et al., 2006). It is assumed that a larger internal audit function has a broader scope of work and is able to cover more areas where (potential) information asymmetries exist. In the following paragraphs, hypotheses will be developed based on the principal/agent problem that exists between the owners of resources (shareholders and debtholders) and the users of resources (management).

### **Diffusion of Ownership**

Based on studies done by DeFond (1992) and Francis and Wilson (1988), explaining the implications of the separation of ownership and control, it can be argued that the more diffused the ownership of the company, the higher the divergence in preferences of the owners and managers and the lower the observability and control of management's actions by the owners. As the diffusion of ownership increases, it is expected that a greater demand for monitoring will be exhibited through a larger internal audit function to monitor the owners' interests. This is reflected in Hypothesis One.

Hypothesis 1: The larger the diffusion of ownership, the larger the internal audit function.

### **Management Share Ownership**

DeFond (1992) argues that the greater the ownership interest of managers, the more closely aligned their preferences are with those of the outside owners. Since owner-managers have an opportunity for entrepreneurial gains, they have incentives to increase the value of the firm rather than shirk (Francis and Wilson, 1988). Although the current popularity of stock-based compensation (Bolton et al., 2006), managers typically own only a relatively small portion of the organisation's shares. They have more incentives to allocate resources in ways that are not necessarily consistent with the interests of non-managing shareholders (Chow, 1982). In Hypothesis Two it is expected that the smaller the managers' ownership of shares, the greater the demand for monitoring, resulting in a larger internal audit function.

Hypothesis 2: The smaller management's share ownership, the larger the internal audit function.

## **Leverage**

Similar to the principal/agent problem between shareholders and management, Jensen and Meckling (1976) argue that the same problem arises out of conflicting incentives of debtholders and management (see also DeFond, 1992). It is argued that as the proportion of debt in a company's capital structure increases, it becomes more likely that the organisation will need monitoring through auditing (cf. Chow, 1982; Francis and Wilson, 1988). Previous research (Abdel-Khalik, 1993; Blackwell et al., 1998; Chow, 1982) supports a positive association between the level of debt and the demand for external auditing. This result is based on the importance of accounting numbers in debt covenants, reducing the information asymmetry between debtholders and management, and the monitoring role of external auditing with respect to the reliability of these accounting numbers. Watts and Zimmerman (1986) indicate that auditor assurance reduces lenders' monitoring costs. To the extent that debt contracts increase the need for external auditing, Carcello et al. (2005a) recently found that this increased need for monitoring also affects a company's investment in internal auditing. Given the focus of internal audit's work, reviewing different types of internal controls (including financial controls), and the direct or indirect impact this has on the reliability of accounting numbers, it is assumed that a positive relationship exists between the proportion of debt and the size of the internal audit function, resulting in Hypothesis Three.

Hypothesis 3: The higher the proportion of debt, the larger the internal audit function.

## **Company Size**

Fama (1980) utilised agency theory to examine the hierarchical relationships that exist within large, divisionalised companies. In this context, the company's top management is viewed as the principal who delegates responsibility and authority to subordinate managers (agents) for effective utilisation of a portion of the firm's resources, leading to moral hazard problems between both levels. Top management would attempt to mitigate this moral hazard problem through available organisational controls including internal auditing (San Miguel et al., 1977). Previous empirical studies have identified a correlation between company size and the demand for both external and internal auditing (e.g. Carcello et al., 2005a). A number of explanations have been suggested. Chow (1982) indicated that as the total amount of potential wealth transfers increases with company size, the related benefits from monitoring increase. Abdel-Khalik (1993) suggests that with increased size it becomes more difficult for principals, in this case top management, to oversee and be cognizant of the enterprise, which

creates a greater demand for internal auditing to compensate for the loss of control. On the cost side, larger companies have opportunities to take advantage of economies of scale when investing in the fixed costs of an internal audit function (Anderson et al., 1993). Once the internal audit function has been established, the marginal cost of its operation is likely to decrease with company size. This leads to Hypothesis Four which relates the size of the company to the size of the internal audit function.

Hypothesis 4: The larger the company, the larger the internal audit function.

### **Number of Reporting Levels**

In a small company with only one level of hierarchy, operations are primarily controlled by means of direct supervision and personal observation. As the company grows, multilayered hierarchies evolve and authority is often delegated down the chain of command (Abdel-Khalik, 1993). The reduced observability in hierarchies can cause loss of control (Williamson, 1967; Williamson and Ouchi, 1981). First, observability of subordinates' actions decreases as the chain of command gets longer. Second, the longer the chain of command, the more likely that communication will become distorted (Katz and Kahn, 1966). Third, communication down the chain of command passes through several filters, which subject it to summarisation, misinterpretation, and possible intentional manipulation (Williamson and Ouchi, 1981). Williamson (1967) argues that as the number of hierarchical levels in the company increases, the demand for monitoring grows, resulting in a larger internal audit function as reflected in Hypothesis Five.

Hypothesis 5: The larger the number of reporting levels within the company, the larger the internal audit function.

### **Geographical Dispersion of the Activities**

Carcello et al. (2005a) suggest that increased organisational complexity resulting from a larger number of foreign subsidiaries, is associated with greater decentralisation, which in turns leads to a greater demand for monitoring. Wallace and Kreutzfeldt (1991) found evidence that a more decentralised company will have a greater propensity to establish an internal audit function. The number of countries in which the company has subsidiaries or operating units is a proxy for the extent of control loss. Based on these findings, the following hypothesis can be formulated:



Hypothesis 6: The larger the number of different countries in which the company has a subsidiary, the larger the internal audit function.

Figure 1 depicts the assumed relationship between the six agency variables and the size of the internal audit function.

[INSERT FIGURE 1 HERE]

## METHODOLOGY

### Target Population

Contrary to most research in this area (e.g. Wallace and Kreutzfeldt, 1991) focusing on the existence of internal auditing, this model explains the size of the internal audit function within Belgian companies. The target population excludes those Belgian companies that do not have an internal audit function, and consists of companies that are known to have an internal audit function, based on the membership database of the Belgian Institute of Internal Auditors (IIABEL). This results in a target population of 260 companies. One can argue that we excluded those Belgian companies that have an internal audit function, but that are not a member of IIABEL. The Belfirst database (Bureau Van Dijk)<sup>2</sup> was used to develop a list of all companies, excluding banks and insurance companies, with more than 1,000 employees. Given previous research on internal auditing in Belgium (Sarens and De Beelde, 2006a; 2006b), these companies can reasonably be expected to have an internal audit function. A list of 175 companies resulted that was almost completely represented by the membership database of IIABEL. So, it can be concluded that the target population is representative for the group of Belgian companies with an internal audit function.

### Data Collection

The data collection for this study consisted of two parts. First and given the limited amount of publicly available data, questions related to agency variables as well as the size of the internal audit function were incorporated into a broader questionnaire on internal auditing practices in Belgium. This questionnaire was sent out in November 2005 to the head of the internal audit department of all 260 companies from our target population. By March 2006,

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<sup>2</sup> The Belfirst database contains the annual accounts of approximately 300,000 Belgian companies.

after an intensive follow-up by e-mail and phone<sup>3</sup>, 85 questionnaires were returned. This represents an overall response rate of 32.69 percent. A first review revealed 12 questionnaires with many missing values. Consequently, these were excluded from further analysis, yielding 73 usable questionnaires. This represents 28.08 percent of the target population, which is similar to recent studies in this area (e.g. Carcello et al., 2005a, Mat Zain et al., 2006).

Second, for the 73 companies that returned a usable questionnaire, archival data were collected from their 2005 annual report from the Belfirst database (for Belgian companies), Amadeus database (for Belgian subsidiaries of a company located in another European country), both issued by Bureau Van Dijk, or a manual investigation of the annual report (for Belgian subsidiaries of a US-based company).

### **Non-Response Bias**

To detect a possible non-response bias, Armstrong and Overton (1977) suggest comparing key constructs between early and late respondents<sup>4</sup>. The analysis reveals no significant differences in terms of number of employees ( $p = .702$ ) and total assets ( $p = .109$ ) between early and late respondents. Comparison of the dependent and independent variables shows only one significant difference between early and late respondents. More specifically, management share ownership (independent agency variable) is significantly higher within the group of late respondents ( $p = .007$ ). Including a dummy variable for late respondents in the regression analysis did not change the results; the dummy variable itself was not significant ( $p > .05$ ) in the agency model. It can be concluded that the data do not suffer from a non-response bias.

### **Variable Measurement**

#### ***Dependent Variable***

The number of internal auditors within the internal audit function (FTE) is the dependent variable in the OLS regression analysis. A closer investigation of the histogram of this variable reveals a strong positively skewed distribution, and an examination of the residuals of the regression analysis indicates a problem of heteroscedasticity. As recommended by Hair

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<sup>3</sup> We gratefully acknowledge the assistance of IIABEL in this part of the data collection.

<sup>4</sup> We consider those respondents returning their questionnaire during the last week of the data collection, who lasted 18 weeks in total, as 'late respondents'.

et al. (2005), the dependent variable was transformed by computing the logarithm of the number of internal auditors to solve this problem. We are convinced that this corrective action will increase both the predictive accuracy of both models and the validity of the estimated coefficients. The dependent variable should be interpreted as a measure of proportional change in the size of the internal audit function.

### ***Control Variables***

The New York Stock Exchange (NYSE) requires all listed companies to have an internal audit function, although it does not address the nature or effectiveness of the internal audit function (SEC, 2003). Therefore, it can be reasonably expected that, due to these institutional requirements (cf. also Chow, 1982), within NYSE listed companies, the size of the internal audit function will be significantly higher. Those Belgian companies that are directly listed on the NYSE or whose parent company is NYSE listed are controlled by including a dummy variable. Some industries face substantial regulatory scrutiny that may increase the importance of internal auditing (Wallace and Kreutzfeldt, 1991). For example, financial institutions are highly regulated and have compliance risks that exceed those in many other industries (Basel Committee, 2001). Therefore, those companies operating in the financial sector (banks and insurance companies) are controlled by including a dummy variable. It can be reasonably expected that these companies will have a larger internal audit function. Data for both control variables were collected through the questionnaire.

### ***Independent Variables***

Consistent with Francis and Wilson (1988) and given the limited availability of data, the diffusion of ownership is measured by the largest individual percentage of stock ownership at the end of 2005. The smaller this percentage, the more diffused the ownership structure. This percentage is obtained from the annual report. The questionnaire also asks for this percentage, which is only used if the annual report did not contain the information. Management share ownership is measured by the percentage of shares that was owned by managers at the end of 2005 (cf. Chow, 1982). For non-US companies, we asked the respondents for an exact figure or an approximation, as this percentage is rarely disclosed in the annual report. Following Carey et al. (2000) and Chow (1982), leverage is measured as the proportion (percent) of total debt compared to total assets. Following Carcello et al. (2005a), DeFond (1992) and Francis and Wilson (1988), replacing total debt by long-term debt leads to the same results. These data were obtained from the 2005 annual report.

Consistent with previous research, total assets as reported in the 2005 annual report are used to measure company size (cf. Carey et al., 2000; Chow, 1982; Wallace and Kreutzfeldt, 1991). Given the non-linear relationship between total assets and the number of internal auditors, the logarithm of total assets reflects a more reliable measure (see also Blackwell et al., 1998; Carcello et al., 2005a). The respondents were asked to specify the number of reporting levels between top management and the lowest operating unit, and the number of different countries in which their company has one or more subsidiaries or operating entities.

### **Common Methods Variance Bias**

According to Hair et al. (2005), common methods variance bias can emerge when dependent and independent variables all come from a single respondent. In order to avoid this bias, two countermeasures were taken. First, the dependent variable (number of internal auditors) is an objective measure rather than a perception. Second, some of the independent agency variables were obtained from a secondary source (annual report).

### **Model Specification**

An OLS regression analysis will be performed to test the agency model (expected signs are between brackets):

$$\text{Ln (Number\_IA)} = a_0 + a_1 \text{ Finance} + a_2 \text{ NYSE} + a_3 \text{ Dif\_Owner} + a_4 \text{ Mgt\_Stocks} + a_5 \text{ Leverage} + a_6 \text{ Ln (Total\_Assets)} + a_7 \text{ Report\_Level} + a_8 \text{ Countries}$$

### ***Dependent variable:***

Ln (Number\_IA)                      Size of the internal audit function measured by the logarithm of the number of internal auditors (FTE)

### ***Control variables***

Finance (+)                              Company operates in the financial industry (bank or insurance company): Dummy variable (0/1)

NYSE (+)                                 Company or parent company is listed on the NYSE: Dummy variable (0/1)

### ***Independent variables***

Dif\_Owner (-)                          Diffusion of ownership measured by the largest individual percentage of stock ownership

Mgt\_Stocks (-)                         Management share ownership measured by the percentage of shares owned by managers

Leverage (+)	Leverage measured by the proportion of total debt compared to total assets
Ln (Total_Assets) (+)	Company size measured by the logarithm of total assets
Report_Level (+)	Number of reporting levels between top management and the lowest operating unit
Countries (+)	Number of different countries in which the company has one or more subsidiaries or operating units

## **EMPIRICAL RESULTS**

### **Descriptive Statistics and Correlations**

Panel A of Table 1 shows a breakdown of the respondents by industry. It is apparent that almost one third (32 percent) of the respondents comes from the production, energy and utility sector, whereas one fourth (26 percent) of the respondents operates in the financial sector (bank or insurance company). Panel B of Table 1 indicates that 22 percent of the responding companies (or their parent company) is listed on the NYSE. Table 2 gives an overview of the descriptive results for the dependent and independent variables and indicates substantial variability. Table 3 shows the correlations and reveals no substantial indication of collinearity between the independent variables. All tolerance values are higher than 0.58, which is above the common cut-off threshold. All variance inflation factor values are lower than 1.74, and are below the threshold (Hair et al., 2005). Hence, multi-collinearity is not a significant problem.

[INSERT TABLE 1 HERE]

[INSERT TABLE 2 HERE]

[INSERT TABLE 3 HERE]

### **OLS Regression Analysis**

The first OLS regression analysis only includes the two control variables and has an F-value of 7.788 ( $p = .001$ ) explaining 16 percent of the variance in the proportional change of the size of the internal audit function. It is clear that the internal audit function is significantly larger in companies who are listed (or their parent company) on the NYSE stock exchange. It should be noted that this variable remains significant in the agency model which confirms the strong influence of institutional requirements (Chow, 1982).

The second OLS regression analysis, testing the agency model, has an F-value of 22.011 ( $p < .001$ ) and explains 70 percent of the variance in the proportional change of the size of the internal audit function, which is relatively high compared to previous studies using these variables (Anderson et al., 1993; Carcello et al., 2005a; Carey et al., 2000; Chow, 1982). It becomes clear that agency variables explain to a high extent the size of the internal audit function in Belgian companies. This OLS regression analysis supports the following hypotheses:

Hypothesis 1: The larger the diffusion of ownership, the larger the internal audit function.

The OLS regression analysis reveals a highly significant ( $p < .01$ ) negative coefficient, indicating that the smaller the individual stake of the largest shareholder, the larger the internal audit function.

Hypothesis 4: The larger the company, the larger the internal audit function.

The OLS regression analysis shows a highly significant ( $p = .000$ ) positive coefficient, indicating that the larger the company, the larger the internal audit function.

Hypothesis 5: The larger the number of reporting levels within the company, the larger the internal audit function.

The OLS regression analysis indicates a highly significant ( $p < .01$ ) positive coefficient, thereby confirming that the larger the hierarchical distance between top management and the lowest operating unit, the larger the internal audit function to compensate for the loss of control at top level.

[INSERT TABLE 4 HERE]

### **Additional Analysis**

Given the institutional requirements, one could wonder whether the agency variables are significantly different between the regulated companies (financial or NYSE-listed) and non-regulated companies (non-financial or non-NYSE listed). Some additional univariate significance tests (ANOVA) were performed, revealing interesting differences. Table 5 shows that financial companies (banks and insurance companies) and NYSE-listed companies are significantly larger ( $p < .05$ ), in terms of total assets, than their non-regulated counterparts. Financial companies seem to have significantly less reporting levels ( $p < .05$ ) than non-

financial companies and are significantly less geographically dispersed ( $p = .006$ ). In contrast, NYSE-listed companies have significantly more reporting levels ( $p < .05$ ) than non-NYSE listed companies. Furthermore, financial companies have a significantly higher leverage ( $p = .000$ ) than non-financial companies.

Contrary to what one might expect, the internal audit function is not significantly larger within financial companies ( $p = .192$ ) than in non-financial companies. When comparing the size of the internal audit function between NYSE-listed companies and non-NYSE listed companies, it is revealed that the internal audit function is significantly ( $p < .01$ ) larger in the former group.

[INSERT TABLE 5 HERE]

## **DISCUSSION AND CONCLUSION**

Complementary to previous studies applying agency theory to explain the existence of internal auditing in companies, this study illustrates that agency theory is also a relevant framework to explain the size of the internal audit function in those companies who already have an internal audit function (Adams, 1994). It can be argued that a larger internal audit function represents a more diverse range of skills and competences and has a broader coverage in their audit work, and therefore, is better able to reduce the information asymmetries and resulting loss of control that is inherent to modern companies. In this study, a distinction was made between the principal/agent problem between the owners of resources (shareholders and debtholders) and the users of resources (management) on the one hand, and between those who delegate responsibilities within the company (top management) and those who take these responsibilities (lower managers) on the other hand. With respect to the first principal/agent problem, it is confirmed that companies with a more diffused ownership structure have a larger internal audit function. This confirms that internal auditing can be considered as a basic monitoring mechanism to reduce the information asymmetry resulting from the separation of ownership and control (Francis and Wilson, 1988; DeFrono, 1992). As this separation is considered as the basic principle behind the demand for corporate governance, this result confirms the growing importance of internal auditing's monitoring role in contemporary corporate governance (Carcello et al., 2005b).

Contrary to the hypothesis, the coefficient in the regression analysis suggests a negative relationship between the leverage and the size of the internal audit function. Contrary to Carcello et al. (2005a), it seems that in this sample internal auditing is not playing a major monitoring role in the contracting relationship between debtholders and management. This confirms, to some extent, previous research demonstrating the important monitoring role of external auditing in this agency conflict (Abdel-Khalik, 1993; Blackwell et al., 1998; Chow, 1982). It seems reasonable that the external auditor has a more valuable role to play when it comes to monitoring the reliability of the accounting numbers. This is consistent with the current scope of internal auditing in a non-Anglo-Saxon environment, focusing more on evaluating operations and processes, with a less dominant focus on the reliability of financial numbers (Sarens and De Beelde, 2006a). Further research could validate this by investigating whether a higher leverage leads to a higher importance of external auditing, reflected by higher audit fees, and whether these higher audit fees can be associated with a smaller internal audit function (cf. Carey et al., 2000).

Furthermore, the results demonstrate that internal auditing is a relevant monitoring mechanism to reduce the internal principal/agent problem (cf. Fama, 1980), thereby confirming San Miguel et al. (1977). Given recent corporate governance requirements, top managers are assigned with increased monitoring responsibilities in order to demonstrate that they have the company 'under control'. In this context, the internal principal/agent problem and the resulting need for monitoring become strongly relevant. Testing the agency model reveals that larger companies and companies with more reporting levels, coping with more potential moral hazard problems between top management and lower managers, have larger internal audit functions.

This result confirms the important relationship between company size and the demand for monitoring through internal auditing to compensate for the loss of control (Abdel-Khalik, 1993). This also suggests that larger companies are better able to take advantage of the economies of scale when investing in the fixed costs of an internal audit function (Anderson et al., 1993). This result also illustrates that the longer the chain of command within the company, the more valuable internal auditing becomes to enhance observability of subordinates' actions and avoid distorted communication (Katz and Kahn, 1966; Williamson and Ouchi, 1981). In these companies, it can be argued that top managers are more confronted with their own limitations, resulting from information asymmetries, in monitoring



the company. The internal audit function seems to be the partner of top management in monitoring the company. The internal audit function, focused on monitoring the internal controls and operations at different levels in the company, provides top management with an important assurance, which enables them to assume their monitoring responsibilities.

It became clear that NYSE-listed companies have significantly larger internal audit functions. Consequently, it can be concluded that institutional requirements in the U.S., stressing the importance of internal auditing, clearly contribute to the recognition and development of the profession. One could wonder whether making an internal audit function also mandatory for European listed companies would elevate the status of the internal auditing profession in continental Europe. Belgium has recently taken some preliminary initiatives in this direction.

It can be concluded that, apart from company size, the diffusion of ownership and the number of reporting levels within the company have the most significant influence on the size of the internal audit function. Additional analysis indicated that some agency variables between regulated and non-regulated companies are significantly different. On the one hand, it was suggested that financial companies encounter more external principal/agent problems given that they were larger and have a higher leverage than their non-financial counterparts. On the other hand, it can be assumed that they encounter less internal principal/agent problems given the lower number of reporting levels and the more limited geographical dispersion of their activities. NYSE-listed companies were larger than their non-NYSE listed counterparts, but have more reporting levels and a wider geographical dispersion of their activities, which leads to the assumption that internal principal/agent problems are more prevalent in this sub-group. Given these interesting differences, further research, building upon a larger number of observations, could test the extent to which the influence of these agency variables on the size of the internal audit function varies between regulated and non-regulated companies.

### **Limitations**

Despite the interesting insights revealed by the agency model, this study has some limitations. Although yielding a reasonable response rate, the absolute number of respondents remains rather low, especially when this group is split into several sub-groups for more detailed analysis. Nevertheless, this is a general disadvantage of survey-based research. With respect to the dependent variable, one could wonder whether other measures like the internal audit budget (Carcello et al., 2005a; 2005b) would lead to the same conclusions. Given the limited

availability of data, the largest individual percentage of stock ownership was used as a proxy for the diffusion of ownership. Besides, a self-reported measure was used to measure management share ownership. One could wonder to what extent these measures are sufficiently reliable. A larger disclosure within the annual report of Belgian companies would solve this measurement problem. Given the low significance level, the results suggest that the geographical dispersion of the activities, measured by the number of different countries in which the company has one or more subsidiaries or operating units, is not capturing the information asymmetry resulting from organisational complexity. New measures, for example recent involvement in mergers and/or acquisitions, could lead to more significant results. From a longitudinal perspective, it would be interesting to consider the change in the size of the internal audit function, for example over the last three years, as the dependent variable, which is probably a better proxy for the importance of internal auditing. Similarly, using the incremental change in each of the independent variables could lead to an even higher explanatory power of this agency model.

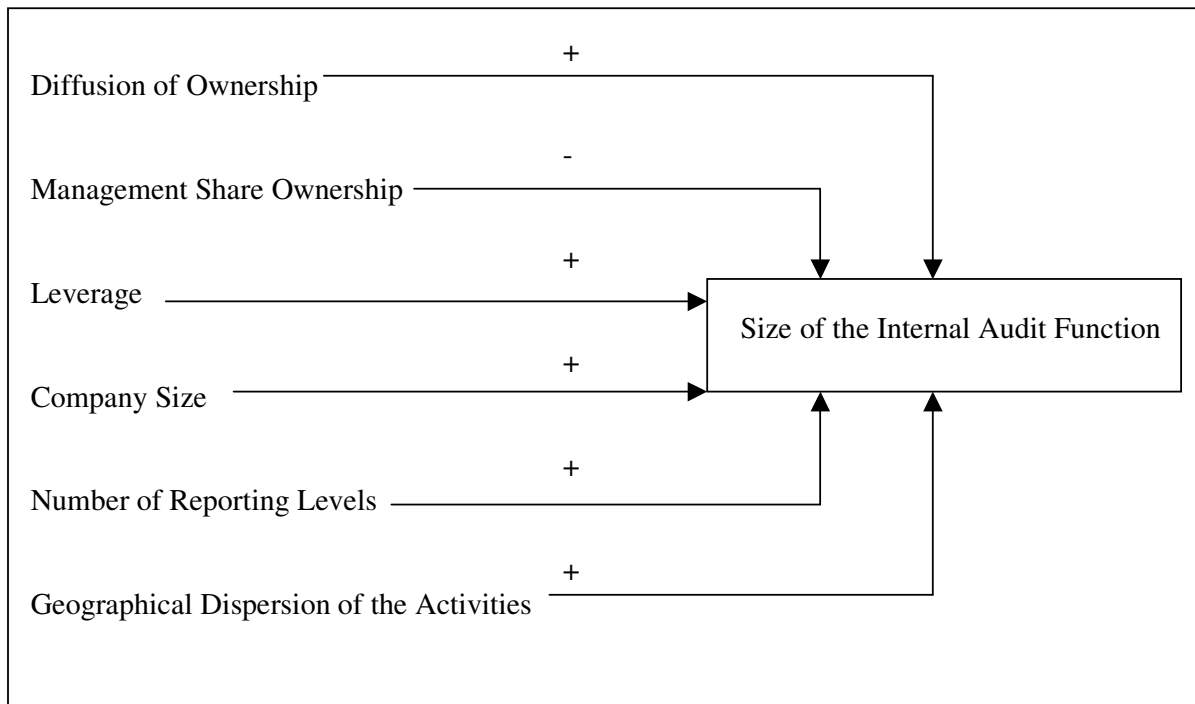
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**Figure 1:**  
**Relationship between Agency Variables and the Size of the Internal Audit Function**



**Table 1 : Breakdown of the Respondents**

	<b>Frequency</b>	<b>Percentage</b>
<b><i>Panel A : Industry</i></b>		
Production, energy, utilities	23	31,50%
Telecom, IT, media, entertainment	9	12,33%
Trade, Transport, logistics	9	12,33%
Professional services	13	17,81%
Financial services and insurances	19	26,03%
	73	100%
<b><i>Panel B : NYSE listing</i></b>		
Company or parent company listed on the NYSE	16	21,92%

**Table 2: Descriptive Statistics for Dependent and Independent Variables (n = 73)**

	Min.	Max.	Mean	S.D.
Number of internal auditors	1	130	10,71	21,19
Ln (Number of internal auditors)	0	5	1,42	1,26
Diffusion of ownership (largest individual percentage of stock ownership)	5,16	100	63,32	29,16
Management share ownership	0	62,65	4,55	10,67
Leverage (total debt / total assets)	10,02	96,99	67,51	21,89
Total assets (in 000 Euro)	9 659	508 761 000	107 000 000	71 834 776,38
Ln (Total assets)	9	20	14,19	2,07
Number of reporting levels between top management and lowest operating unit	1	10	4,38	1,93
Number of countries in which the company has one or more subsidiaries or operating units	1	100	14,51	18,40

**Table 3: Correlation Matrix**

	Finance	NYSE	Dif_Owner	Mgt_Stocks	Leverage	Ln (Total Assets)	Report_Level	Countries
Finance	1							
NYSE	-.088	1						
Dif_Owner	.115	.029	1					
Mgt_Stocks	.147	-.098	-.173	1				
Leverage	.422**	-.145	-.090	.047	1			
Ln (Total Assets)	.297*	.285*	-.094	-.184	.238*	1		
Report_Level	-.282*	.257*	-.063	-.072	-.140	.156	1	
Countries	-.321**	.221	-.236*	-.047	-.130	.204	.173	1

\* : p<.05    \*\* : p<.01



**Table 4: OLS Regression Analysis (n = 73)**

Dependent variable: ln (Number\_IA)

	Expected Sign	Control Variables		Agency Model	
		Coefficient	T-value	Coefficient	T-value
Finance	+	.061	.564	.004	.049
NYSE	+	.428	3.940***	.148	2.078**
Dif_Owner	-			-.196	-2.823***
Mgt_Stocks	-			-.106	-1.531
Leverage	+			-.119	-1.612
Ln (Total Assets)	+			.660	8.214***
Report_Level	+			.198	2.792***
Countries	+			.062	.838
R <sup>2</sup>		.182		.733	
Adjusted R <sup>2</sup>		.159		.700	
F-value		7.788***		22.011***	

\* : significant at p = .10

\*\* : significant at p &lt; .05

\*\*\* : significant at p &lt; .01

**Table 5: Univariate Significance Test (ANOVA)**

	<b>Financial Companies (n = 19)</b>	<b>Non-Financial Companies (n = 54)</b>	<b>Significance Test</b>		<b>NYSE-Listed Companies (n = 16)</b>	<b>Non NYSE-Listed Companies (n = 57)</b>	<b>Significance Test</b>	
			<b>F</b>	<b>p-value</b>			<b>F</b>	<b>p-value</b>
Number of Internal Auditors	16.19	8.78	1.737	.192	25.04	6.68	10.628	.002
Diffusion of Ownership	68.93	61.35	.950	.333	64.93	62.87	.062	.804
Management Stocks	7.17	3.63	1.566	.215	2.60	5.10	.683	.411
Leverage	82.98	62.07	15.366	.000	61.55	69.19	1.533	.220
Company Size	15.22	13.83	6.888	.011	15.30	13.88	6.273	.015
Number of Reporting Levels	3.47	4.70	6.137	.016	5.31	4.12	5.030	.028
Number of Countries	4.63	17.98	8.131	.006	22.13	12.37	3.642	.060





**PAPER 2:**  
**BUILDING A RESEARCH MODEL FOR INTERNAL AUDITING:**  
**INSIGHTS FROM LITERATURE AND THEORY SPECIFICATION CASES**

Paper two is the first paper dealing with the second research question of this dissertation. After explaining the size of the internal audit function (macro level) in paper one, this paper comes up with new organisational variables influencing internal audit practices (micro level). Each of these organisational variables will be studied in more detail, both qualitatively and quantitatively, in the following papers.



**BUILDING A RESEARCH MODEL FOR INTERNAL AUDITING:  
INSIGHTS FROM LITERATURE AND THEORY SPECIFICATION CASES<sup>5</sup>**

**Gerrit Sarens**

**Ignace De Beelde**

**Abstract:** This study identifies three organisational variables that have an influence on internal auditing practices and specifies how each of them can exert its influence. This study is based on a literature review, combined with insights from theory specification cases; and contributes to the literature by developing a specific and structured research model. The extent to which internal auditing practices are focused on the provision of assurance, the formulation of recommendations, or the performance of separate consulting activities is influenced by: (1) the stakeholders of internal audit; (2) the organisational support for internal audit; (3) the status of the internal control system.

**Keywords:** internal auditing, research model, theory specification cases, organisational variables.

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## INTRODUCTION

*“The area of internal auditing is ripe for a wide variety of research (Rittenberg, 1999; 35)”*

In this study, we follow the recommendation made by Rittenberg (1999), who stresses that academic research in internal auditing should move beyond treating internal auditing as an extension of the work that is performed by the external auditor. This study encompasses the broader nature of internal auditing that is evolving in practice and confirmed by the revised definition of internal auditing and by the new Professional Practices Framework (IIA, 2004).

Although extensive practitioner literature on specific internal auditing topics exists, the academic literature in this area is rather limited (Kalbers and Fogarty, 1995; Vinten, 1996) and suffers from a lack of specific and well-structured research models that facilitate the understanding of contemporary internal auditing practices (Ratliff et al., 1988; Boyle, 1993). Few studies explained the existence of an internal audit function (Anderson et al., 1993; Carey et al., 2000) as well as the size of the internal audit function (Sarens, 2007) relying on traditional agency variables. This study takes these explanations for the existence and the size of the internal audit function for granted and goes one step further by investigating internal auditing practices in more detail. The existing literature, as well as the IIA Standards and Practice Advisories (IIA, 2004), suggests that internal auditing practices are influenced by several organisational variables, like the stakeholders of internal audit, organisational support for the internal audit function, and the status of the internal control system. Based on a focused literature review, combined with insights from six theory specification cases within Belgian companies, this study contributes to the literature by confirming and further specifying the influence of these organisational variables on internal auditing practices. As the profession has changed significantly during the last decade, the final aim of this study is to develop a more specific and structured model, adapted to the current state of the profession, in order to guide further research in this area.

At the Belgian level, at the time of data collection (Summer 2004), little regulation or corporate governance guidelines had a significant influence on internal auditing practices. The Belgian Code on Corporate Governance was published in December 2004 and refers only very limitedly to internal auditing. Actually, private companies are only encouraged to install an internal auditing function, without any legal obligation.



This paper is structured as follows. The next section provides some necessary background on the internal auditing profession, followed by a third section dealing with the research questions and methodology of this study. The fourth section describes three organisational variables influencing internal auditing practices, by combining insights from existing literature with empirical evidence from six theory specification cases. Besides describing the limitations of this study, the final section summarises major insights into a specific and structured research model linked with additional suggestions for further research.

## **THE INTERNAL AUDITING PROFESSION: EVOLUTION AND CURRENT STATE**

The roots of internal auditing lie in the financial control area. In the early decades of its existence, the profession was charged with the task of measuring and evaluating the effectiveness of different types of control, evaluating the correctness of financial transactions and checking compliance with applicable laws and procedures. The objective of the function was to assist members of the organisation in the effective discharge of their responsibilities (Bou-Raad, 2000; Brink and Witt, 1982; Rittenberg and Covaleski, 1997).

When analysing the evolution of internal auditing practices, Gupta and Ray (1992) noticed a shift from examining financial records and fraud investigations towards more efficiency and economy audits (i.e. management or operational audits) and the provision of recommendations for future actions (see also Vinten, 1991). According to Allott (1996) and Thevenin (1997), the contemporary internal auditor must determine whether organisational objectives have been achieved. By incorporating a business perspective into current control and compliance processes, the internal auditor is becoming more like an indispensable management assistant or internal business partner. The result is a hybrid and pro-active auditing function that meets the organisation's dual need for assurance and for value-added suggestions on business improvement. When carefully examining the content of these contributions from the practitioner literature published during the 1990's, we already can recognise most of the new elements that were incorporated into the revised definition, published by the IIA in 1999:

*“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its*

*objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2004)”.*

The incorporation of the added value concept was the underlying principle for the revision of the internal auditing definition. In order to add value, internal auditors must embrace the forces of change in their business environment (e.g. higher demand for consulting oriented services) and expand their role in organisations. The incorporation of the consulting concept is one of the major adjustments made in order to better reflect contemporary internal auditing practices.

As one of the first academics, Nagy and Cenker (2002) addressed the question of whether or not the new definition actually reflects the day-to-day activities of internal auditing departments. As expected, their respondents confess that the audit focus shifted several years prior to the definitional change and that the new definition simply better reflects existing practice.

Based on the new definition, we can make a distinction between two types of internal audit activities: assurance activities and consulting activities, both clearly defined in the latest revision of the Standards (IIA, 2004).

*Assurance activities “involve the internal auditor’s objective assessment of evidence to provide an independent opinion or conclusion regarding a process, system or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved in assurance services: (1) the person or group directly involved with the process, system or subject matter – the process owner, (2) the person or group making the assessment – the internal auditor, and (3) the person or group using the assessment – the user (IIA, 2004)”.*

Based on an early framework developed by San Miguel et al. (1977), we can summarise that most assurance activities consist of four dimensions: evaluating, diagnosing, informing and recommending. In other words, based on the evaluation of evidence, the internal auditor reports an opinion on the existing processes and internal controls, completed by an overview of specific, correctible weaknesses. In addition, the internal auditor suggests possible improvements in these processes and internal controls, and recommends specific steps to

improve their functioning. The proposed improvements and recommendations, that comprise most internal audits, should be considered to be a 'by-product' of the regular assurance activities. According to Kowalczyk (1987), evaluation and recommendations are both constantly in the auditor's mind throughout the audit. Courtemanche (1986) emphasises that the ability to recommend solutions to problems is based on years of experience and organisational wisdom that have been acquired in the performance of ascertainment and appraisal tasks.

The concept recognises that there are other ways for internal auditing to provide assurance to the organisation besides auditing against predefined or prescribed criteria. Traditional auditing services, such as financial audits, compliance audits and operational audits, as well as newer forms of assurance stemming from control and risk management evaluations, are incorporated into the definition under a broader umbrella (Krogstad et al., 1999, McNamee, 2000, Wagner, 2000). Although companies did not always formally recognise the internal audit's role as a provider of internal consulting, a recent study by Woodward and Selim (2004) revealed that a majority of internal auditors in the UK and Ireland carried out consulting assignments before the 1999 change in the definition.

Consulting activities are defined by the Standards as *“being advisory in nature and generally performed at the specific request of an engagement client. The nature and scope of consulting engagements are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the persons or group offering the advice – the internal auditor, and (2) the person or group seeking and receiving the advice – the engagement client (IIA, 2004)”*.

An internal auditor can expand his or her activities by proactively offering counsel and advice, by helping to solve problems and by participating in the reengineering of processes, the development of systems and the establishment of new organisations or processes (Anderson, 2003). McCall (2002) asserts that, by providing consulting services, many auditors are helping to ensure that management sees the auditing function as essential to achieving organisational goals and objectives. Although earlier studies by Brody and Lowe (2000) and Flesher and Zanzig (2000) emphasised that internal auditors should maintain a proper balance between acting as a consultant and providing independent evaluations, in order to remain independent and objective, more than one third of the internal auditors surveyed in

a study by Woodward and Selim (2004) indicates that they allocate more than 20 percent of their time to consulting assignments. Moreover, two thirds agrees that internal audit's involvement in consulting will increase in the future.

## **RESEARCH QUESTIONS AND METHODOLOGY**

Complementary to studies that explained the existence and size of the internal audit function (Anderson et al., 1993; Carey et al., 2000; Sarens, 2007; Wallace and Kreutzfeldt, 1991), several internal auditing research manuscripts published in the 1980s and 1990s have suggested theoretical frameworks to describe, explain and predict the multiple roles of internal audit. For example, Mautz et al. (1984) studied developments impacting internal auditing to offer suggestions on how internal auditing can most appropriately respond to such developments. Albrecht et al. (1988) also developed a framework which they offered to internal audit groups to evaluate and improve their effectiveness. Additionally, Boyle's (1993) framework identified four roles / relationships, addressing internal as well as external responsibilities, a framework believed to capture the broad nature and scope of internal auditing *at that time*. Because of the continuous changes with which the internal auditing profession has had to cope, we are convinced that research frameworks need to be updated and refined on a regular base.

Similar to Boyle (1993), we combined the existing literature with insights from our recent case studies within six Belgian companies, in order to develop a more specific and structured model to guide further research in internal auditing. More specifically, we formulated a qualitative answer on the following research questions:

- Which *new* organisational variables influence internal auditing practices?
- How do these *new* organisational variables influence internal auditing practices?

Our cases can be considered theory specification cases. In other words, we took existing theories or findings into the field to assess whether they capture the heterogeneity and complexity of contemporary internal auditing practices. We kept in mind that core concepts and relationships may need to be re-conceptualised, refined or elaborated in order to come up with a more specific and structured research model (Eckstein, 1975; Keating, 1995).

It is important to notice that qualitative samples tend to be purposive, rather than random. In other words, the selection of the companies for this study was partially theoretically driven and partially based upon experience with the internal audit profession in Belgium. We did not want to generalise the findings to other settings. Under these circumstances, we talk about analytical generalisation, in which a previously developed theory is used as a template with which to compare the empirical results of the current case studies (Yin, 1994).

Based on previous empirical research, identifying a correlation between organisation size and demand for both external and internal auditing (e.g. Anderson et al., 1993; Chow, 1982; Wallace and Kreutzfeldt, 1991), we found it adequate to control for organisation size and selected six large (considering the Belgian corporate context) companies (more than 1.000 employees). Moreover, we included an equal number of manufacturing and service companies. Additionally, our experience with internal audit in Belgium incited us to include a majority of companies (four) with a small internal audit department (less than five internal auditors) and only a minority (two) of companies with large internal audit departments (more than five internal auditors). Appendix 2 of this dissertation provides more details on the six cases.

We used interview data supplemented by archival data obtained from the interviewees (Chief Audit Executives or hierarchically equivalent), like the internal audit charter, the audit planning, audit reports and audit committee reports in order to triangulate<sup>6</sup> the interview data. We used an open-ended interview guide and interviews lasted from 80 to 105 minutes. Each interview was tape recorded and transcribed one or two days after the interview took place.

We used a systematic analytical protocol, suggested by Miles and Huberman (1994), to enhance the reliability of this qualitative analysis. After an early analysis of the transcriptions and documents, we moved on to the coding process. First, an initial coding process, one week after the interview, was executed by one researcher. That same researcher executed a second coding session about five to seven weeks after the interview. Subsequently, the coding process was redone by a second researcher, independently from the first one. The level of coding reliability in the three sessions averaged 85 percent, which is within the norms of 80 to

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<sup>6</sup> Triangulation is supposed to support a finding and thereby enhance its validity by showing that independent measures of it agree with it or, at least, do not contradict it (Miles and Huberman, 1994).

90 percent. Further, we summarised the major findings from each interview and each document into a standardised and comparable matrix, which facilitated cross-case analysis. Table 1 summarises the main insights of this cross-case analysis. Besides the existing literature, this forms the basis for our development of a more specific and structured research model.

[INSERT TABLE 1 HERE]

## **ORGANISATIONAL VARIABLES INFLUENCING INTERNAL AUDITING PRACTICES**

A focused review of the existing literature reveals three organisational variables that can have an influence on internal auditing practices. In this section, we will describe these organisational variables and how they can have an influence on internal auditing practices, combining existing literature and empirical evidence from our theory specification cases.

### **Stakeholders of Internal Audit**

Roth (2003) stresses that internal auditors must take into account their specific clients or stakeholders when they want to identify the practices that will add the most value. Moreover, internal audit also must raise stakeholders' expectations by showing them how much value they can add. Additionally, Hermanson and Rittenberg (2003) recognise the need to take into account the influence of an internal auditor's stakeholders on the orientation of the internal auditing activities. This stimulated us to get deeper into the influence of this organisational variable, taken into account that serving several masters is a difficult game to play (cf. Paape et al., 2003).

### ***Literature Review***

Attribute Standard 1110, on organisational independence (IIA, 2004), stipulates that the chief audit executive (CAE) should report to a level within the organisation that allows the internal audit activity to accomplish its responsibilities. More specifically, the IIA believes that, to achieve necessary independence, the CAE should report functionally to the audit committee or its equivalent (Practice Advisory 1110-2).

Article 39 of the proposed directive on Statutory Audit, published by the European Commission (2004), stipulates that the audit committee shall monitor the financial reporting process, the effectiveness of the company's internal controls, its internal audit where applicable, and its risk management system. Given the current working scope of internal audit, the IIA (2004) recognises that audit committees and internal audits have interlocking goals. A strong working relationship with the audit committee is essential for each to fulfil its responsibilities to senior management, board of directors, shareholders, and other outside parties (see also Goodwin and Yeo, 2001; Turley and Zaman, 2004). Regular meetings between the audit committee and internal auditing make it more likely that the audit committee remains informed and knowledgeable about relevant issues related to their own monitoring responsibilities (Raghunandan et al., 2001). Therefore, a recent study by the IIA (2003) found that audit committees are more concerned with the evaluation and opinion of internal auditors regarding whether internal controls are adequate, the (financial) data provided by managers are reliable, laws and regulations are being followed and assets are safeguarded. Thus, assurance-oriented activities regarding risk management and internal control are expected to add more value to audit committees.

For administrative purposes, the IIA (2004) recommends that the CAE report directly to the chief executive officer of the organisation (Practice Advisory 1110-2). Although this potentially can lead to a limitation in scope or in reporting of results, the IIA recognises that some CAEs report administratively to the chief financial officer. Besides, Performance Standards 2010, 2020 and 2060 (IIA, 2004) mention that the CAE should consider the input of senior management (including CEO and/or CFO) in the internal audit planning. The CAE also should report periodically to senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Due to this strong interaction with the CEO and/or CFO, it can be expected that these last ones are in a position to exert significant influence on the internal audit function.

Given senior management's own executive and monitoring responsibilities over operations, processes and internal controls, the IIA (2003) suggests that, besides the independent and objective evaluation and opinions contained within an internal audit (assurance), management should be highly interested in recommendations to improve the efficiency of operations and processes and the adequacy of internal controls. Moreover, Griffith's study (1999) found that providing a more constructive contribution, by means of active involvement in the assessment

and management of business risk, should enhance a financial director's perception of the internal audit function. More specifically, managing the control and risk self assessment process, or having significant involvement in its delivery, provides the opportunity to directly support the financial directors' requirements and responsibilities in this regard. In other words, providing recommendations and more active involvement in consulting activities regarding risk management and internal control would be expected to add more value for senior management.

### ***Empirical Evidence from Theory Specification Cases***

In four of the six companies, internal audit has a functional reporting relationship with the audit committee. Although the audit committees spend sufficient time on internal audit topics during their meetings, it becomes clear that the interaction between internal audit and the audit committees is rather limited: *"quite often my presentation is followed by silence... I do not receive any question from the audit committee members, they just move on with their agenda"*. The interviewees as well as a detailed analysis of audit committee reports reveal that the role of the audit committee vis-à-vis internal audit often is limited to the formal approval and follow-up of the audit mission, audit planning, and occasionally an evaluation of some important audit conclusions. In these cases, the absence of important topics, suggested by the audit committee, in the internal audit planning, reflects the limited influence of the audit committee on internal auditing practices.

Two companies (case one and three) do not even have an audit committee. In these two companies, internal audit practices are to a large extent influenced by senior management, their main stakeholder, and clearly more focused on providing recommendations for the (immediate) improvement of processes and internal controls based on the knowledge and expertise of internal audit. Moreover, in these two companies, internal audit is more engaged in consulting activities. Respectively, 42 percent and 69 percent of the audit planning is dedicated to activities like procedure development and modification, training of key personnel, facilitation of risk assessment workshops,... The Chief Audit Executive in one of these two companies even admits that his function *"was clearly promoted within the organisation as a consulting function and his agenda was mainly directed by the CEO"*.

Another company (case four), where the audit committee is clearly the main stakeholder of internal audit, represents the opposite extreme. By providing a lot of input for the internal



audit planning, based on its own responsibilities and need for information, the audit committee has a strong influence on internal auditing practices. In this company, audit reports clearly reflect a greater focus on assurance aspects (e.g. a detailed description of audit findings in order to explain thoroughly how the internal auditor came to certain conclusions or opinions). The Chief Audit Executive stresses: *“actually, the audit committee determines my agenda, it suggests which cycles to audit as well as specific ad hoc priorities. In fact, it wants assurance on processes and controls in order to avoid surprises”*.

In all companies, internal audit has an administrative reporting relationship with senior management (CEO or CFO). In most cases, the scope of internal auditing practices was, to a large extent, influenced by senior management and, therefore, more focused on formulating recommendations for the further improvement of the processes and internal controls and even providing separate (*ad hoc*) consulting activities like assistance with the integration after a merger, and assistance with new software implementations,... As one of the interviewees clearly states: *“OK, we are still focused on providing an opinion on internal controls, but as management asks us to think together with them about the improvement of the internal control system, we are becoming more and more involved in control reengineering”*. In general, it becomes clear that the assurance role internal auditing mainly is playing for the audit committee sometimes conflicts with the management demands for consulting activities.

In other words, our empirical insights provide support for the expected influence of internal audit stakeholders like the audit committee and senior management (CEO and/or CFO) on internal auditing practices. The influence of these internal audit stakeholders should be taken into account, when studying internal audit practices (see Figure 1).

### **Organisational Support for the Internal Auditing Function**

Although previous studies found evidence on the effect of performing certain types of internal audit activities on organisational support for internal audit (e.g. Woodward and Selim, 2004), until now, no explicit literature exists on the opposite relationship, namely the influence of organisational support on internal auditing practices. Therefore, we had to use existing theories in other research areas, like applied psychology (Eisenberger and Huntington, 1986), to obtain a better understanding of the concept ‘organisational support’.

### *Literature Review*

A review of the Standards and Practice Advisories (IIA, 2004) clearly shows that a sufficient level of organisational support is necessary for the existence as well as the day-to-day functioning of internal auditing. More specifically, Practice Advisory 1000-1 indicates that the purpose, authority, and responsibility of the internal audit activity should be defined in a charter. The CAE should seek approval of the charter by senior management as well as acceptance by the board. Besides internal audit's position within the organisation and the scope of its activities, this charter also should authorise access to records, personnel, and physical properties relevant to the performance of engagements. Moreover, Practice Advisory 1110-1 clearly suggest that internal auditors should have the support of senior management and the board, so that they can gain the cooperation of engagement clients and perform their work free from interference. It should be clear that both aspects are needed to adequately perform internal audits. As mentioned before, the CAE should report administratively to the CEO (Practice Advisory 1110-2). Administrative reporting typically includes the approval of the audit budget by the CEO (see also Performance Standard 2020), a necessary condition to run the internal audit function.

According to Eisenberger and Huntington (1986), organisational support can be described as the extent to which the organisation values employees' contributions and cares about their well-being. In this context, we focus on the first aspect, namely the extent to which the organisation values the contributions of the internal audit function and the direct and indirect effects of this valuation on internal auditing practices. We changed the formulation of the 36 statements developed by Eisenberger and Huntington (1986) to measure organisational support towards a focus on the internal auditing function as a whole, instead of on individual internal auditors, and then summarised these statements into five constructs<sup>7</sup>:

- Opinion of the organisation on whether or not the internal auditing function is replaceable by an external service provider.
- Support received from management and collaboration with management.
- Consideration of internal auditing as an important strategic function.
- Acceptance and appreciation of internal auditing opinions and recommendations.
- Distribution of resources to the internal auditing department.

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<sup>7</sup> It should be clear to the reader that constructs one to four represent subjective elements (perceptions, beliefs). Conversely, construct five refers to an objective fact (figures).

Note that the second and the fifth construct reflect what we found in the Standards and Practice Advisories of the IIA (2004). Given the fact that consultative or advisory activities are mostly performed at specific client request and often support them in strategically important projects (cf. Practice Advisory 1000.C1-2), we expect that a higher level of organisational support will stimulate management to ask internal audit support through the performance of value-adding consulting or advisory activities. Two previous empirical studies found indications for this relationship.

Case studies done by Rittenberg and Covalleski<sup>8</sup> (1997) suggest a direct relationship between specific aspects of organisational support (as defined above) and the proportion of consulting activities. When internal auditing gets strong management support and is considered to be a strategic and important function, more consulting activities are performed, mostly at specific management request. Conversely, a lack of management support and the neglect of internal auditing as a strategic, important function is associated with the *traditional assurance approach*, reflected by a “tick and bash” audit approach.

Moreover, a worldwide study by Birkett et al. (1999) suggests that management’s view of the role of internal auditing affects the types of work that are undertaken by internal auditors. They found that management’s lack of awareness of the role of internal audit results in non-cooperation during the audits and non-implementation of recommendations. Similarly, we can reasonably assume that management’s view of internal auditing also underlies the level of support they will provide to internal auditing, and probably the amount of resources they will distribute to internal audit, other aspects of organisational support. Furthermore, Van Peurseem (2005) found indications that acting alone and without broad management support, can be truly ineffective for internal audit. Additionally, Nagy and Cenker (2002) revealed that it is management who ultimately determines the orientation of internal audit. Birkett et al.’s study (1999) indicates that countries where there exists a lack of awareness by management of the role of internal auditing and its potential to assist in achieving organisational objectives (internal audit is seen as a ‘necessary evil’) are characterised by a higher focus on traditional assurance oriented activities (e.g. financial audit, compliance audit,

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<sup>8</sup> Although these cases (see chapter five of their book) were done with the intention of identifying some characteristics in relation to what works well and what does not in the case of outsourcing, we noted a link between certain aspects of organisational support and the type of internal auditing activities.

fraud detection). On the contrary, countries with a higher level of awareness about the value of internal audit show a lower proportion of pure internal control reviews and fraud detection.

Besides this direct relationship, arguments can be found for an indirect influence of organisational support, through the concept of organisational commitment, on internal audit activities. Ensuring that internal auditors perceive that they are valued by the organisation and that they can depend on the organisation is shown to result in increased organisational commitment of the internal audit department (Kwon and Banks, 2004), that should create an intrinsic 'obligation' to care about their organisation's welfare (Eisenberger et al., 2001). Porter et al. (1974) conceptualised the construct 'organisational commitment' as having three primary components: (1) a strong belief in and acceptance of the organisation's goals and values; (2) a willingness to exert considerable effort on behalf of the organisation; and (3) a strong desire to maintain membership in the organisation. Taking this into consideration, we expect that, when internal auditing has a higher level of organisational commitment, a larger proportion of their audit activities will be focused on the formulation of value adding recommendations to improve the effectiveness and efficiency of organisational processes and internal controls. Moreover, the internal auditor probably will be more willing to become engaged in consulting activities. By doing this, the internal auditor actively assists the organisation in achieving its goals and objectives.

### ***Empirical Evidence from Theory Specification Cases***

We found evidence for two constructs of organisational support, based on the definition of Eisenberger and Huntington (1986), that can be linked directly with internal auditing practices. We observed, as suggested by Rittenberg and Covaleski (1997), a larger proportion of consulting activities in those three cases where internal auditing clearly receives more management support and a more active collaboration with management exists, and where the function in general, as well as their opinions and recommendations more specifically, are more accepted and appreciated by the people in the organisation.

These three cases illustrate that stronger management support manifests itself in a relatively higher frequency of meetings with management (formal and informal) and a more meaningful dialogue with management, reflecting an active interest on their part in audit results and the follow-up of recommendations and action plans. Furthermore, interviewees indicate a closer collaboration with management during the different stages of an internal audit (e.g. when

performing risk assessments or internal control evaluations, or developing action plans). A higher extent of acceptance and appreciation of the internal auditing function is reflected by a higher degree in which the internal auditor's opinions and recommendations are followed (in these cases, on average 90 percent of the recommendations are implemented within one year after the audit), by a higher degree in which internal auditors are trusted (e.g. as facilitators of whistle-blowing) and by the absence of a negative connotation (no "police man image"). In these three cases, the internal audit planning clearly indicate a higher involvement of internal audit (through so-called special consulting engagements) in strategically important projects like acquisitions or ERP implementations. Moreover, internal audit is also more engaged in so-called emergency consulting engagements, often initiated through *ad hoc* questions by management (e.g. in case of an unexpected deterioration of the credit situation or an urgent need to improve the stock registration of raw materials).

In most cases, we notice a certain level of organisational commitment on behalf of the internal auditing department. This is illustrated most clearly by the fact that their mission is aligned with overall organisational objectives, and that their planning focuses on high organisational risk areas (risk-based auditing) and reserves a sufficient proportion of working time for *ad hoc* management requests (25 percent, on average). Although it is confirmed by some interviewees that "*if internal auditing gets strong management support, internal auditing in turn is a strong support for management*", our empirical data do not provide us with sufficient evidence to conclude that, on one hand, a higher level of organisational support creates more organisational commitment on behalf of internal audit and, on the other hand, more organisational commitment incites internal auditing to focus more on the provision of value-adding recommendations. Complementary to the indications found in the literature, we only suggest that taking this (intervening) variable into account can enrich the understanding of internal auditing practices (see Figure 1).

### **Status of the Internal Control System**

The most recent definition of the IIA (1999) clearly states that internal auditing "*evaluates and improves the effectiveness of risk management, control, and governance processes*". Although there exists quite extensive literature on the role of internal auditing with respect to internal controls (e.g. Brink and Witt, 1982; Kowalczyk, 1987; Ratliff et al. 1988; Spira and Page, 2003; Vinten, 1991; Whittington and Adams, 1982), we did not identify any specific literature dealing with the influence of the status of the internal control system on internal

auditing practices. Therefore, it would be interesting to look at which components of the internal control system have an impact on internal auditing practices and how this influence is manifested.

### ***Literature Review***

Consistent with methodology described in previous literature, we refer to the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 1992) that defines internal control 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 related to the effectiveness and efficiency of operations, the reliability of financial reporting and the compliance with applicable laws and regulations. Internal control consists of five interrelated components. The *control environment* provides the atmosphere in which people conduct their activities and carry out their control responsibilities. It serves as the foundation for the other components. Within this environment, management *assesses risks* that can have a negative impact on the achievement of specified objectives. *Control activities* are implemented to help ensure that management directives to address the risks are carried out. Meanwhile, relevant *information* on risk and control activities is captured and *communicated* throughout the organisation. The entire process is *monitored* and modified as conditions warrant.

As suggested by the COSO Report (1992), an internal auditing department or single internal auditor often plays a very significant (monitoring) role in effective internal control because of its organisational position and authority in an entity, and the objectivity with which it carries out its activities. More specifically, Performance Standard 2120 (IIA, 2004) states that the internal audit activity should assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. As internal control evaluations are part of internal audit's regular duties, we expect that, in the opposite direction, the status of the internal control system will have an effect on the internal auditing practices themselves. Besides management, internal auditors should be among the first to recognise significant internal control failures and to formulate recommendations for improvement. By doing this, internal auditors are seen to contribute to a more effective internal control structure that subsequently improves the quality of information for decision-making purposes (Bou-Raad, 2000).

If the control environment in general, and internal controls more specifically become weaker, there is a greater likelihood that material errors or irregularities will not be prevented or detected (Marden et al., 1997). Given their mission, internal auditing will then focus primarily on the *development* and *improvement* of the internal controls by giving advice and recommendations. Internal auditors are likely to be the most knowledgeable in controls and are able to provide management with sound advice to develop and improve internal controls (Bou-Raad, 2000; Bou-Raad and Capitanio, 1999).

### ***Empirical Evidence From Theory Specification Cases***

Our cases provided us with indications that the control environment (the first component of the COSO framework) and the effectiveness of the internal controls (the third component) have the greatest influence on internal auditing practices.

In all cases (but especially in the first three), we found, to some extent, examples of weak internal controls (e.g. no time registration, no entrance registration, many non-uniform manual controls not integrated with processes, no adequate inventory protection, and lack of segregation of duties). Instead of having formal and integrated internal controls, there often exists a kind of trust-based culture, where controls and procedures only are followed on an *ad hoc* basis for the most critical aspects of the business. In the first three cases, this is reinforced by a rather weak control environment. More specifically, the tone-at-the-top is not always control-oriented, which is sometimes an undesirable consequence of a strong focus on efficiency improvements and cost reductions at the expense of internal controls. Moreover, our data indicate that the attitude of top management is not always sufficiently control-minded, especially when staffed with non-economically trained people like engineers. In other words, there exists a low level of control awareness in these cases. Some interviewees confess that “*as long as there are no problems, we don’t have to follow rules and procedures too strictly*” and “*we find an up-to-date registration of procedures not relevant, because people are not interested in it*”.

The existence of weak internal controls, especially in the first three cases, can be associated with a relatively higher focus of internal auditing activities on improvements to the internal control system. By providing a thorough internal control review, followed by extensive and well-documented recommendations and possible solutions (e.g. the implementation of more uniform, integrated and real-time internal controls, adapted to the specific organisational

characteristics), internal audit actively contributes to the improvement of the internal control system and, by doing so, adds value to the organisation (cf. Bou-Raad, 2000; Bou-Raad and Capitanio, 1999). Moreover, in the first three cases, internal audit is also involved in consulting activities, like training in the development of procedures or facilitation of control-self-assessment exercises, focused on the creation of an enhanced level of control awareness within the organisation and thereby an improvement of the control environment.

Our empirical insights confirm our expectation by illustrating that the status of the internal control system (especially the control environment and internal controls) of a company have an important influence on internal audit practices (see Figure 1).

### **CONCLUSIONS AND MODEL FOR FURTHER RESEARCH**

Current internal auditing practices encompass assurance activities (including recommendations for improvement) and consulting activities. This study, based on a focused literature review combined with insights from theory specification cases within six Belgian companies, identified three organisational variables that have an impact on internal auditing practices and specified how each of them can exert its influence. It should be mentioned that the influence of these three organisational variables on internal audit practices should be interpreted for each variable separately. Figure 1 summarises these variables and relationships into a model to guide further research:

[INSERT FIGURE 1 HERE]

First, literature as well as our empirical insights reveal the influence of internal audit's stakeholders on internal auditing practices. On one hand, active interactions with senior management (CEO and/or CFO) exert a large influence on the internal auditing scope and stimulates additional focus on the formulation of recommendations for the further improvement of processes and internal controls and even become involved, to some extent, in separate consulting activities. On the other hand, interactions with the audit committee are, in most cases, not intensive. Consequently, the influence of the audit committee on internal auditing practices also is limited. Nevertheless, based on the literature and one specific case, it can be expected that more intensive interactions with the audit committee will incite internal auditing to emphasise their assurance role.



Secondly, appealing to existing theory in applied psychology, we investigated the influence of organisational support on internal auditing practices. A larger proportion of consulting activities can be noticed in those companies where internal auditing receives stronger management support and where more active collaboration with management exists. This also applies where the function in general and the opinions and recommendations of the internal audit are to a higher extent accepted and appreciated. Although we find, in most cases, indications of a certain level of organisational commitment on behalf of the internal auditing department, our data do not provide us with sufficient support to conjecture on the role and influence of this variable. Consequently, further investigation of this variable, individually or as an intervening variable (see Figure 1), definitely is of interest for further research.

Thirdly, we find that two components of the internal control system have an influence on internal auditing practices. Weak internal controls, reinforced by a weak control environment, are associated with a more active focus of internal auditing practices on the improvement of the internal control system, through the formulation of recommendations to improve the internal controls or the involvement in specific consulting activities focused on enhancing the control awareness within the organisation.

### **Limitations and other Suggestions for Further Research**

We want to draw attention to the fact that the relative weight or importance of each of these variables in determining the internal auditing practices is different for each company. As the main purpose of this study was to develop a flexible model to guide further research, we do not have the intention to neither conclude on the combined effect of the three organisational variables on internal auditing practices nor to generalise specific findings from our case studies. Moreover, we are convinced of the existence of interrelated effects between these variables. Further research should integrate these variables and determine their relative weight.

Although Goodwin (2004) suggests that internal auditing practices in the private and public sector are not very different from each other, Woodward and Selim (2004) still found some differences between these sectors, especially related to the performance of consulting activities. Therefore, it would be interesting to apply and adapt the currently-proposed research model to study internal auditing practices in the public sector.

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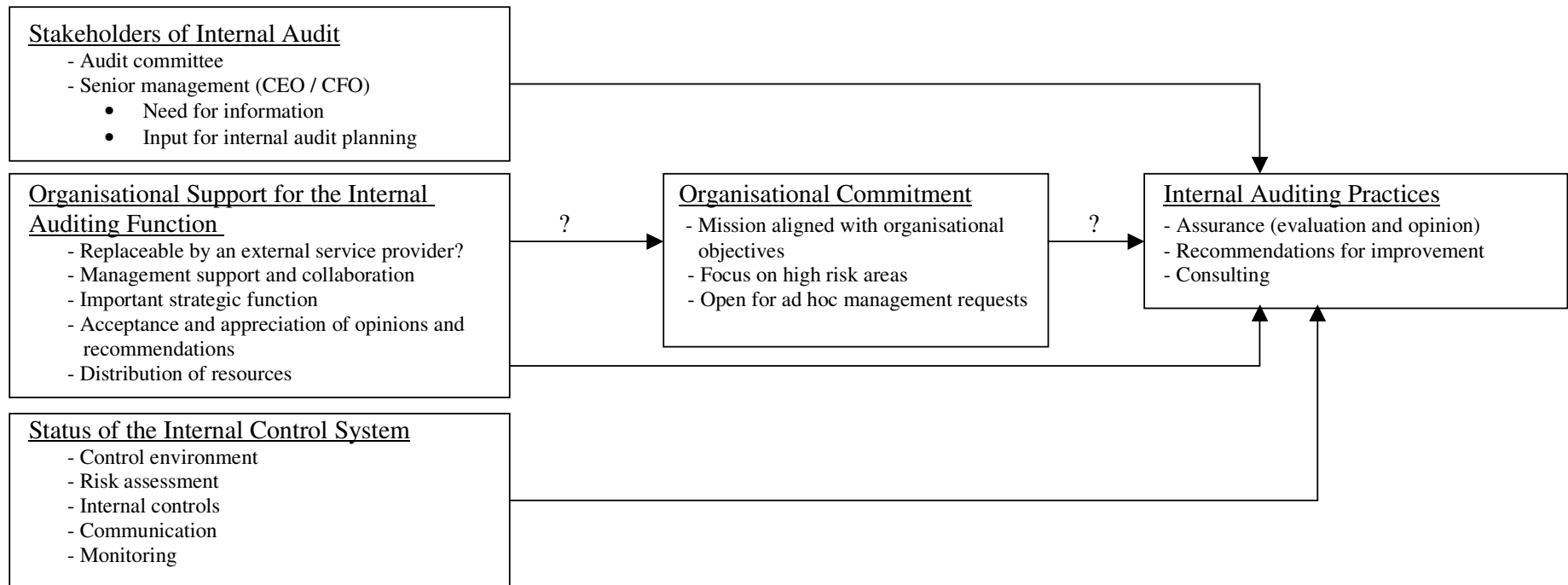
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**Table 1: Cross Case Analysis (Based on Collected Data)**

	<b>Case 1</b>	<b>Case 2</b>	<b>Case 3</b>	<b>Case 4</b>	<b>Case 5</b>	<b>Case 6</b>
<b>Internal Auditing Practices</b>	- Focus on recommendations (incl. those to improve the internal controls) - 69% consulting activities (incl. those to improve control awareness)	- Focus on recommendations (incl. those to improve the internal controls) - 23% consulting activities (incl. those to improve control awareness)	- Focus on recommendations (incl. those to improve the internal controls) - 42% consulting activities (incl. those to improve control awareness)	- Focus on assurance  - 15% consulting activities (no dominant focus on improvement of control awareness)	- Focus on recommendations (no dominant focus on improvement of internal controls) - 20% consulting activities (no dominant focus on improvement of control awareness)	- Focus on recommendations (no dominant focus on improvement of internal controls) - 39% consulting activities (no dominant focus on improvement of control awareness)
<b>Internal Audit's Stakeholders</b>	- No audit committee present  - Senior management is main stakeholder	- Limited functional reporting relationship with the audit committee  - Strong influence of senior management	- No audit committee present  - Senior management is main stakeholder	- Audit committee is main stakeholder  - Limited influence of senior management	- Limited functional reporting relationship with the audit committee  - Strong influence of senior management	- Limited functional reporting relationship with the audit committee  - Strong influence of senior management
<b>Organisational Support</b>	- More management support - More active collaboration with management - More acceptance and appreciation	- Limited management support - Limited collaboration with management - Limited acceptance and appreciation	- More management support - More active collaboration with management - More acceptance and appreciation	- Limited management support - Limited collaboration with management - Limited acceptance and appreciation	- Limited management support - Limited collaboration with management - Limited acceptance and appreciation	- More management support - More active collaboration with management - More acceptance and appreciation
<b>Status of the Internal Control System</b>	- Weak control environment - Weak internal controls	- Weak control environment - Weak internal controls	- Weak control environment - Weak internal controls	- Moderate control environment - Moderate internal controls	- Strong control environment - Moderate internal controls	- Moderate control environment - Moderate internal controls

**Figure 1: Proposed Research Model**









**PAPER 3**  
**INTERNAL AUDITORS' PERCEPTION ABOUT**  
**THEIR ROLE IN RISK MANAGEMENT:**  
**A COMPARISON BETWEEN US AND BELGIAN COMPANIES**

Paper three elaborates further on the second research question of this dissertation by describing contemporary internal audit practices and investigating in more detail some of the variables that influence these internal audit practices (micro level). It should be noted that this paper only deals with the perceptions of internal auditors, whereas paper four and five take into account other stakeholders' (audit committee and senior management) expectations and perceptions.



**INTERNAL AUDITORS' PERCEPTION ABOUT  
THEIR ROLE IN RISK MANAGEMENT:  
A COMPARISON BETWEEN US AND BELGIAN COMPANIES<sup>9</sup>**

**Gerrit Sarens**

**Ignace De Beelde**

**Abstract:** In addition to a number of quantitative studies, this paper extends in a qualitative and comparative way the understanding of the specific role of internal auditors in risk management within US and Belgian companies. In order to get adequate data, ten case studies were conducted. In the Belgian cases, internal auditors' focus on acute shortcomings in the risk management system creates opportunities to demonstrate their value. Internal auditors are playing a pioneering role in the creation of a higher level of risk and control awareness and a more formalised risk management system. In the US cases, internal auditors' objective evaluations and opinions are a valuable input for the new internal control review and disclosure requirements mentioned in the Sarbanes Oxley Act.

**Keywords:** internal auditors, risk management, Sarbanes Oxley Act, qualitative study

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## INTRODUCTION

By stating that the internal audit activity should evaluate and contribute to the improvement of risk management, control and governance, the Institute of Internal Auditors (2004) recognises the assurance and consulting role of internal auditors in corporate governance. Until now, no empirical research on the role of internal auditors in risk management (including internal control) has been conducted within a Belgian context. In this study, we elaborate in more detail how internal auditors perceive their current role in risk management within the specific Belgian context, where internal auditing is still a relatively young profession and where many (large) companies have recently established an internal audit function. Moreover, it is important to notice that the Belgian environment is different from the Anglo American environment where the internal auditing profession is more developed and where listed companies are subject to more stringent corporate governance regulations. By incorporating four Belgian subsidiaries of US listed companies in this study, we are able to investigate the influence of the Sarbanes Oxley Act (2002) on internal auditing practices and compare this with internal auditing practices in an emerging corporate governance context. Therefore, this study is a response to Scarbrough et al.'s (1998) call for studies to be undertaken in different jurisdictions with different corporate governance requirements.

In order to collect data, ten case studies were conducted. More specifically, we interviewed Chief Audit Executives in ten large manufacturing and service companies located in Belgium and collected relevant documents in order to provide an adequate qualitative view of the role of internal auditors in risk management and marked differences between Belgian companies (emerging corporate governance context) and Belgian subsidiaries of US companies (established corporate governance context).

This paper is structured as follows. The next section outlines the necessary theoretical background on risk management. The third section deals with the role of internal auditors in risk management and gives an overview of the existing empirical studies in this area. The fourth section focuses on the methodology, followed by the fifth section with the results of our interviews and document analysis. The final section formulates conclusions, discusses the practical implications and outlines some major limitations of this study combined with suggestions for future research.

## THEORETICAL BACKGROUND ON RISK MANAGEMENT

For more than a decade, risk management in general, and internal control more specifically, have been considered as fundamental elements of organisational governance. Over 60 percent of the respondents of a KPMG survey (2002) in eight European countries believed that their systems of risk management and internal control add value to their organisation. As a consequence, risk management is beginning to be perceived as a new means of strategic business management, linking business strategy to day-to-day risks and then optimising those risks in order to realise value. More recently, PricewaterhouseCoopers' Eight Annual Global CEO Survey (2005) revealed that CEOs worldwide consider governance, risk management and compliance as value drivers and a source of competitive advantage. However, effective governance, risk management and compliance are not easily achieved and CEOs are struggling with their implementation.

Selim and McNamee (1999b) define risk as 'a concept used to express uncertainty about events and/or their outcomes that could have a material effect on the goals and objectives of the organisation'. The key activity with respect to risk is to manage it. Selim and McNamee (1999a) point out that this starts with a *risk assessment* where the organisation (management) attempts to estimate the probable consequences of threats and opportunities (risk identification, measurement and prioritisation), followed by *risk management*, where decisions need to be made about how to manage the perceived consequences of that risk. It should be clear that internal controls are only one of the means to manage key organisational risks. Other devices used to manage risks include the transfer of risks to third parties, sharing risks and the withdrawal from unacceptably risky activities. Similar to Krogstad et al. (1999) and Spira and Page (2003), this study takes the view that a company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives and the promotion of effective governance processes. This may be regarded as essential to the governance of the organisation and must be confirmed regularly. The UK Turnbull Report (1999), giving explicit guidance on the implementation of the UK Combined Code (1998), can be considered as one of the first public documents in the EU that clearly emphasises the relationship between internal control and risk management. Finally, *risk communication* deals with articulating the results of the previous two components to the interested shareholders within and outside the organisation. In this study, we will focus on how internal auditors perceive their role in each of these three aspects.

*Internal control* has been defined in many international studies and these definitions, although not identical, show great similarities. We summarise the most important aspects based on the COSO Framework (1992) and The Turnbull Report (1999). The system of internal control comprises those elements of an organisation (including its resources, systems, processes, culture and structure) that support people in the achievement of the organisation's objectives. They facilitate the effective and efficient operation of companies by enabling them to respond appropriately to significant business, operational, financial, compliance and other risks. This includes safeguarding assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed. Furthermore, internal controls help ensure the quality of internal and external reporting, which also includes procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action. Finally, internal controls help ensure compliance with applicable laws, regulations and internal policies. It is important to note that a sound system of internal control provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives by circumstances which may reasonably be foreseen.

International guidelines state that boards are ultimately responsible for the system of internal control. In practice, this often means that the 'tone at the top' is set by the board but it is the role of management to identify and evaluate the risks (risk assessment) and design, operate and monitor an appropriate system of internal control (risk management). The board should, at least annually, conduct a review of the effectiveness of the system of internal control, a responsibility that is often delegated to the audit committee. The Turnbull Report (1999) states that effective systems of internal control are embedded into a company's operations, form part of the corporate culture and are capable of adapting to evolving risks arising from changes within the company and in the business environment. As Power (2004; 20) states: "internal control is an unshakeable part of the moral economy of organizations".

The increased (regulatory) demands for accountability has made organisation's internal control systems part of public policy debates on corporate governance. Many national corporate governance reports and reforms include recommendations for internal controls and reporting on internal controls. Complementary to the rise of internal control, the public significance of internal auditors increased (Maijoor, 2000).



## **THE ROLE OF INTERNAL AUDITORS IN RISK MANAGEMENT**

Internal auditors are certainly exhorted in the professional literature to embrace the opportunity to contribute to the achievement of corporate objectives through risk management. Chambers (2000) observed the increasing references to risk (management) over the last five years in professional journals related to internal audit. It is clearly demonstrated that internal auditors aspire to this reframing of their role in terms of risk management. An important step was the new definition of internal auditing issued by the IIA in June 1999, which clearly states that “the internal auditing activity should evaluate and contribute to the improvement of risk management, control and governance”. In other words, a significant opportunity for internal audit emerge to demonstrate its potential to add value, to break away from its historical characterisation as the ‘organisational policeman and watchdog’ (Morgan, 1979, p. 161).

According to Spira and Page (2003), recent corporate governance guidelines assume that risks can be objectively identified, quantified and thus strategically managed. Consequently, expertise in risk management techniques and knowledge about the internal control system become a source of power which enable internal auditors to advance and play an important role within their organisation. Following their suggestion, this study wants to investigate in a Belgian context how internal auditors play these trumps in order to become a proactive player in risk management.

The respondents of a study conducted by KPMG (1999) in the US recognise that one important way to contribute in today’s changing business arena is to refocus internal auditors towards the critical risks and exposures that can determine an organisation’s success or failure. This requires internal auditors to gain a better understanding of the key business risks and the impact they can have on the organisation’s ability to build shareholder value (risk assessment). Internal auditors must also be able to assess the responses to key exposures (e.g. internal controls) and determine if those responses are sufficient or relevant (risk management). There was a high level of agreement among executives that internal auditors should shift part of their focus to strategic risk rather than focusing only on compliance.

Recently a limited number of (academic and semi academic) studies has been performed in this specific area. Based on an electronic survey to all members in the worldwide GAIN<sup>10</sup> database, the IIA concluded that risk assessment and risk management had become an integral part of the internal audit activity and it was believed to be important to both management and audit committees, although the audit committee had a stronger focus on risk than management. The Leung et al. (2003) large scale study within Australian companies revealed that a large majority of internal auditors regarded risk management (74 percent) and internal control (91 percent) as important internal audit objectives. In practice, most of their audit work was performed with an emphasis on risks and controls. Moreover, a majority reported regularly and detailed on topics like risk and internal control. Paape et al. (2003) concluded, based on a survey conducted in 15 European countries, that risk assessment and risk management are making inroads into the internal audit function. Two third of their respondents said they advise and/or support in this area. Similarly, Allegrini and D'Onza (2003) revealed that, within large Italian companies, internal auditors contributed to the risk management process. They were involved in customising the risk management methodology to the organisation, carried out consulting services in risk management activities or facilitated control and risk self assessments. Summarised, internal auditors are potentially important providers of independent evaluations of the risk management and internal control system (assurance), eventually combined with more practice-oriented management assistance (consulting) in this area. In this study, we take these rather general insights for granted and investigate in a more qualitative and descriptive way how internal auditors play a role in risk assessment, risk management and risk communication.

Based on their interviews with Chief Audit Executives in the US, Cenker and Nagy (2004) found that the Sarbanes Oxley Act (2002), increasing the financial reporting oversight responsibilities for management, audit committees and external auditors, had changed the relationship between internal auditors and its constituents, at least for the short term. Many executives are seeking the assistance from their internal auditors in satisfying the Section 404 requirements, leaving internal auditors with the important task of ensuring that the corporation's internal control system is properly documented and tested. Managements' call

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<sup>10</sup> GAIN, which stands for Global Audit Information Network, is a network of Chief Audit Executives who share benchmarking data and receive periodic benchmarks for similar audit activities. The audit functions pay a fee to belong to GAIN and therefore are not random members. However, the IIA has worked diligently to keep costs down and therefore the GAIN database is fairly representative of their constituency. For further information, please check: [http://www.theiia.org/index.cfm?doc\\_id=4865](http://www.theiia.org/index.cfm?doc_id=4865).

for Section 404 assistance has caused a short term shift of internal auditors' orientation towards a higher focus on financial reporting. Despite this change in orientation, the formal organisational position of internal auditors, as well as their long term view, have not changed, due to the general belief of the CAEs that this shift is only a short term reaction to the SOX Act. They are convinced that their orientation will shift back to where it was prior to the SOX Act in the next few years. As we are going to investigate whether a similar (short-term) shift can be observed within Belgian companies and Belgian subsidiaries of US companies, this study can be considered as a supplement to Cenker and Nagy's conclusions.

Summarised, by finding a qualitative and descriptive answer on the following research questions, this study attempts to complement the existing literature on internal audit:

- How do internal auditors, within a Belgian context, perceive their current role in risk assessment, risk management and risk (and internal control) communication?
- Do we observe, within a Belgian context, a shift towards a greater financial emphasis in internal auditors' role in risk management?
- What are marked differences between Belgian companies (emerging corporate governance context) and Belgian subsidiaries of US companies (established corporate governance context) with relation to internal auditors' role in risk management?

Before proceeding to a review of our empirical results, we reflect on some methodological issues.

## **METHODOLOGY**

The motivations for this study reflect a desire to enrich and extend our understanding of the specific role of internal auditors in risk management. The relative lack of qualitative and descriptive research in this area indicates that theory specification case studies (Keating, 1995) were an appropriate and even indispensable way to investigate this topic. Moreover, Vinten (1996) stimulates the use of qualitative research, as this is more in tune with the nature of the profession.

The selection of the companies for this study was theoretically driven, not by a concern of representativeness, as we did not want to generalise the findings to other settings. More specifically, the selection of the companies was based on two criteria. Previous research and anecdotal evidence has revealed that the total amount of potential wealth transfers, and thus

the related benefits from undertaking monitoring, increases with firm size. Moreover, the opportunity to obtain economies of scale through the establishment of an internal audit department also increases with firm size (Chow, 1982; Parkinson, 2004). Therefore, we controlled for *firm size* and selected companies with at least 1,000 employees. Furthermore, we included four subsidiaries of US companies listed on the New York Stock Exchange, because of our interest in specific differences between Belgian companies (called hereafter “the Belgian cases”) and US linked companies (called hereafter “the US cases”). It is important to notice that we did not take into account the age and size of the internal audit department when selecting companies. For an overview of the ten cases, we refer to Appendix 2 of this dissertation.

Similar to Page and Spira (2004) in the UK, we conducted in depth interviews with the Chief Audit Executive in each of the 10 companies. The interviews lasted from 60 to 90 minutes, were tape recorded and transcribed immediately after the interview took place<sup>11</sup>. The valuable insights from six preliminary interviews formed a basis to develop a more structured and focused interview guide for this specific study on the role of internal audit in risk management.

After explaining the purpose of this study, the interview started with some general questions about the number of internal auditors, the functional and administrative reporting relationships, the content of the audit charter, the input for the audit planning, the distribution of working time and the disclosure of risk and internal control statements. The next part of the interview focused on the stage of development of the risk management system and the possible role of internal auditors in the implementation or improvement of a formal risk management system. The major part of the interview dealt with the specific role of internal auditors in risk assessment, risk management through internal controls and risk and internal control communication. We were interested in the purpose of their involvement and asked for specific examples. To round off the interview, their expectations for the (near) future were discussed.

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<sup>11</sup> These steps in the data collection procedure were performed by research assistants. They had the necessary background on the research topic and were sufficiently briefed in advance related to the specific objectives of this study. A closed interview guide was used in order to minimise interviewer bias. Moreover, interviews were transcribed literally so no information could get lost.

In order to triangulate the interview data, we used archival data, like the internal audit charter, the audit committee charter, the internal audit planning, risk and control assessment questionnaires, risk and control assessment reports (e.g. matrices), internal audit reports, audit quality surveys and risk and internal control disclosures from the annual report (where applicable), obtained from the interviewees.

While interview data may enhance construct validity by studying phenomena in their natural context, it is suggested by Lillis (1999) to use a systematic analytical protocol to enhance the reliability of our results. More specifically, we referred to the most important steps from the analytical protocol suggested by Miles and Huberman (1994). First, all interview transcripts and archival documents were coded. Next, we structured and summarised the insights of each company in order to get an overview of the most remarkable insights. These insights were submitted to an IIA round table for early feedback<sup>12</sup>. The ‘translation’ of these insights into a standardised and comparable matrix was an important tool to facilitate cross company analysis. Finally, we compared the ten cases in order to discover certain patterns and reassure ourselves that conclusions from one company were not idiosyncratic.

The fifth section discusses in detail the results of our empirical work, structured around the differences between both corporate governance contexts.

## **EMPIRICAL RESULTS**

### **General Insights on Risk Management Systems in the US Cases**

In all US cases, we see a well developed risk management system and a high overall focus on risks and internal controls. In these cases, the risk management methodology is formalised, standardised, transparent and documented. On the one hand, these companies use their own developed risk assessment methodology, in most cases consisting of questionnaires resulting in a company specific risk matrix. On the other hand, the internal control methodology is to a large extent based on the COSO framework (1992), as strongly recommended by the SOX act. As a consequence of the strong SOX influence, there is a higher level of risk and control awareness in these companies. Most people in the US cases are convinced that “*without a good internal control system, you are not able to reach your business objectives, that is*

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<sup>12</sup> The researcher actively contributed to a round table on risk management in small audit shops organised by the Belgian chapter of the IIA (January 18<sup>th</sup>, 2005).

*simply impossible*". All board, audit committee and management responsibilities related to risk management and internal controls are clearly defined in and communicated through internal control policies, audit committee charters, company websites (intranet and internet) and annual reports. Moreover, all these US companies (recently) developed, in most cases at high corporate level, separate risk management functions independent from the internal audit function. These functions focus on the most important strategic and financial risks and are often involved in risk assessment activities.

### **General Insights on Risk Management Systems in the Belgian Cases**

In only two of the six Belgian cases did we see a formalised and standardised risk management system. All other companies do not have a formal risk management system at corporate level. After analysing relevant documents, we could not find clearly defined risk and control responsibilities for the board, the audit committee and management. In such a context, companies are rather dealing with risks in a reactive instead of a proactive way. One of the interviewees admits that *"they are dealing with risks, but especially after a risk has occurred. You should spend some time in our company to understand this, it's part of our culture"*. In most of these companies we see, influenced by a constantly changing business environment on the one hand and recent corporate governance pressures on the other hand, clear intentions for an evolution towards more formalisation and more focus on risk management. *"In the past, risk management and internal control were considered of minor importance. Thanks to certain corporate scandals, these topics appeared on the radar screen of the board and top management"*. In all these cases, internal auditors, sometimes in collaboration with the separately developed risk management function (in three of the four cases) plays an important pioneering role in this formalisation process. As they are convinced of the usefulness of such a formalised risk management system, internal auditors try to create (more) risk and control awareness on behalf of the board and management. A low level of awareness is considered as one of the main reasons for the lack of formalisation: *"when someone asks us: who is responsible for internal control? We always have to answer them: you are responsible!"*.

### **General Insights on Internal Auditors' Role in Risk Management**

Before elaborating the specific differences between the internal auditors' roles in the Belgian cases and the US cases, we want to focus the attention on the general insights from both groups of cases.

Firstly, we can conclude that the role of internal auditors in risk management for all cases is time specific and changes quickly, especially as a consequence of the implementation of new corporate governance regulations. Secondly, it becomes clear that the constantly emerging changes in the business environment (e.g. tendency towards further globalisation, new technologies) can be considered as an important basis for the role of internal auditors in risk management. Changes in the environment lead to new risks, which create the need for new internal controls to manage these risks. Each of these two steps creates opportunities for internal auditors to play an influencing role. Related to the first step, internal auditors can work in a risk based way. Most interviewees are convinced that an evolution towards a higher level of risk based auditing is absolutely needed and crucial when internal auditors want to play a role in risk management. A regular update of their own risk assessments allows them to anticipate new risks and adjust their audit planning and assurance efforts to these new risks. Related to the second step, internal auditors can actively contribute to the adjustment of the internal controls to these newly emerged or changed risks. In other words, a proactive (consulting) role in the development or improvement of internal controls creates (new) ways to demonstrate their value. Thirdly, we have to admit that internal auditors are concerned about their capacities to play an important role in risk management. In most cases, quality or satisfaction surveys are conducted in order to investigate whether they meet the expectations of their stakeholders. Fourthly, we have to remark that all consulting activities are only performed on specific (top) management request and often in close collaboration with (top) management. The contemporary consulting role of internal auditors has changed towards a larger focus on internal controls instead of a more general business focus in the past (e.g. involvement in efficiency improvements of operations or integration after mergers and acquisitions). It has to be noticed that most interviewees are convinced that the orientation of their consulting role will change again in the (near) future: *“in one or two years, when this whole internal control hysteria is calmed down, I’m sure that internal audit will again focus more on business aspects... wait and see”*.

Let us now go deeper into the role of internal auditors in the three aspects of risk management (risk assessment, management and communication) suggested by Selim and McNamee (1999a).

In all cases, internal auditors are rather limited in their involvement in *risk assessment* activities. More specifically, management remains ultimately responsible for risk

assessments. Internal auditors often perform their own risk assessments, but largely based on input coming from management and other risk management functions. Internal auditors are playing a kind of integration role. For those internal auditors working in a risk based way, the output of these risk assessments is an important input for the global internal audit planning as well as for individual audit assignments. In other words, internal auditors' role in risk assessment can be considered as a necessary input for their evaluation of the internal control system, an integral part of their assurance role. The consulting role of internal auditors in *risk assessments* is in both groups of cases rather limited. More specifically, by facilitating risk-self-assessments (e.g. development of risk assessment questionnaires and assistance with the implementation of these questionnaires), internal auditors assist management in fulfilling their risk assessment responsibilities.

It was clearly illustrated that the provision of an independent and objective evaluation of the internal control system (*risk management*) remains the major assurance task of internal auditors. One of the internal auditors stresses that "*the evaluation of the internal control system is the core business of internal audit*". Internal auditors review and appraise the adequacy, effectiveness and efficiency of the internal control system in order to provide its independent opinion on it. It becomes clear that most audits focusing on compliance with formal procedures and guidelines constitute an integral part of this assurance role. Recommendations on the further improvement of the internal control system (e.g. suggestions for new controls or update of existing procedures) should be considered as an integral and valuable aspect of this assurance role.

When looking at their consulting role in *risk management*, internal auditors are actively involved in the development (e.g. design of a new questionnaire), reengineering (e.g. update of an existing questionnaire) and facilitation (e.g. help with filling in the questionnaire) of control-self-assessments (performed by management). This clearly contributes to a further enhancement of the transparency and documentation of the risk management system. One of the internal auditors emphasises: "*control-self-assessment? That is something really special! We really need to introduce people of each level in the company to this technique. It takes about 25 percent of our time this year*". It is important to notice that some interviewees stress the temporary character of this specific consulting activity: "*the facilitation of control-self-assessments is a kind of one shot event where internal audit assists management but from the beginning, it should be clear that the business unit has to take over these responsibilities as*



*soon as they have enough competences*". Consequently, it is expected that internal auditors' involvement in this type of activity will decrease in the future.

Furthermore we see, for the US as well as the Belgian cases, an involvement of internal auditors in the development, reengineering or improvement of the internal controls. By doing this, internal auditors try to transfer their knowledge of internal controls to management. On the one hand this can be a rather informative role in which internal auditors are asked to give a (limited) number of recommendations. On the other hand, they can be proactively involved in this process (e.g. assistance with the development of an internal control manual in case of the implementation of a new ERP system). They "*want to be actively involved in internal control reengineering, instead of only watching and rejecting*". The interviewees clearly admit that the valuable knowledge spillover effects to their assurance role outweigh the potential loss of independence that can arise as a consequence of their involvement in these consulting activities.

It is recognised by all our interviewees that internal auditors play a crucial role in the spread of 'best practices' through their own developed company wide network (*risk and control communication*). Management often benefits from internal auditors as a benchmarking source for the effectiveness and efficiency of their risk assessment and internal control practices. One of our interviewees gives a clear example: "*when we see that our Belgian entity has performed good risk assessments, we can recommend the management in for example our Dutch entity, to meet their Belgian colleagues to learn from their way to perform risk assessments*". Moreover, it is important to see that their communication role contributes to the creation or further improvement of risk and control awareness.

Internal auditors' reports on risks and internal controls are considered as an important communication instrument to a wide range of beneficiaries. In some cases, internal auditors develop and maintain a centralised risk database containing the output of the various risk assessments performed by management and internal audit themselves. It should be emphasised that a formalised, standardised, transparent and well-documented risk database represents an essential communication instrument. In other words, the input (risk database) as well as the output (reports) of their assurance role, fulfil an important communication role in the corporate risk management system.

Additionally, the output of certain consulting activities is also part of the range of possible communication instruments. As we have mentioned above, internal auditors are sometimes involved in the development of internal control manuals that are spread throughout all levels of the organisation. Moreover, internal auditors often develop risk and control assessment questionnaires and provide management training as part of their facilitation role in risk- and control-self-assessments. All these instruments aim at a formalised, standardised, transparent and well-documented way of risk and internal control communication.

### **The Specific Role of Internal Auditors in Risk Management in the US Cases**

After analysing the received audit reports, we can conclude that in the US cases internal auditors' assessments and evaluations of the internal control system are, strongly influenced by Section 302 and 404 of the SOX Act, clearly more focused on the provision of a global (instead of a fragmented) overview and opinion on the state of internal control. Internal auditors are expected to provide annual and even quarterly reports on the overall effectiveness and efficiency of the internal control system to the audit committee, CEO, CFO and other members of top management. Our interviewees emphasise the value of these reports as input for the disclosure statements these last three parties have to make: *“the CEO and CFO are really interested in our evaluations and opinions, especially because they have to put their signature under the internal control statement and because they can go to jail when these statements are not correct!”* In this first phase after the approval of the SOX Act, internal auditors' consulting role in risk management is in the US cases mainly oriented towards a further improvement of the transparency and documentation on risks and internal controls, which is considered as a valuable contribution to the compliance with new disclosure requirements.

Especially for the US cases, we wanted to investigate in more detail to what extent the assurance role of internal auditors is influenced by the SOX focus on financial controls and procedures for financial reporting. In three of the four US cases, we see a more extensive (administrative) reporting relationship with the CFO, as he/she is finally responsible for the design, implementation and effectiveness of financial controls as well as the related disclosures in the annual report. We can wonder whether this does not impair the organisational independence of the internal auditors. Moreover, internal auditors' work is clearly more oriented towards the evaluation of internal controls related to financial reporting. It is confirmed by the interviewees that they have recently paid more attention to the link

between processes, accounting and financial reporting. We can conclude that in a majority of the US cases, a general evolution towards more internal auditors' work focused on financial controls was manifested. One internal auditor reveals that *"since two years, we incorporated much more financial audits in our audit planning, nowadays it even takes about 60% of our time"*. We can wonder whether this should (only) be considered as a temporary 'over-reaction' on the new wave of corporate governance requirements...

### **The Specific Role of Internal Auditors in Risk Management in the Belgian Cases**

After analysing the six Belgian cases, it becomes clear that in four cases the internal audit department can be considered as a 'small audit shop' consisting of only one or two internal auditors. It is stressed by the interviewees that limited resources (e.g. budget for personnel, operational costs and training) are an important constraint for their possibilities to play a significant role in risk management: *"when you don't get enough resources, you will never be able to work thoroughly"*. Although internal auditors have good and ambitious intentions, it is hard to convince people in these organisations of the value of the internal audit function. This can be linked with the fact that internal auditing is a relatively 'new' profession in Belgium, especially when compared with the US or UK. The majority of (large) Belgian companies have recently created an internal audit function (cf. cases nine and ten). As a consequence of recent changes in national and international corporate governance regulations the internal audit function gets now more attention and support from the board and management, which certainly creates new opportunities for them to become a significant player.

Although until now there is no obligation for companies listed on Euronext Brussels to disclose internal control statements, in four of the six Belgian cases the board (including the audit committee) and top management are preparing themselves for compliance with such disclosure requirements in the (near) future. In these cases, internal auditors are (again) playing a pioneering role. Internal auditors have recently started, similar to their US colleagues, to sporadically provide overall assessments and reports on the internal control system in order to anticipate these future disclosures and create more awareness for this topic on behalf of top management and the board. As our interviewees expect that a next revision

of the recently published Belgian Code on Corporate Governance<sup>13</sup> will contain more clear requirements for internal control disclosures, the importance of the assurance role of internal auditors in Belgium is expected to increase in the (near) future.

Concerning the evolution towards a greater financial focus in the internal audit work, the six Belgian cases can be divided into two categories. In a first group of three cases, we do not see an important shift in the internal auditors' work. These interviewees stressed that in the past, present and future they look at all segments of internal controls, including procedures and controls related to financial reporting and financial controls. In a second group, we generally see an enhanced attention to the quality of the financial reporting. Similarly to the majority of US cases, these internal auditors have recently paid more attention to financial and accounting aspects. This shift can be considered as a part of their pioneering role in relation to expected disclosure requirements in the (near) future.

For the Belgian cases, internal auditors' consulting role in risk management can be linked to the global stage of development of the risk management system. In the two cases with a (strongly) formalised risk management system, internal auditors' consulting role in risk management is very limited. In the four other cases without a (completely) formalised risk management system on corporate level, their consulting role is much more elaborated. In these cases, internal auditors' proactive involvement in the development and improvement of internal controls is considered as an important aspect of their pioneering role. Internal auditors play a valuable role because they actively enhance risk and control awareness on behalf of the management. They should realise that internal control is an integral part of their responsibilities, because *“some management levels do not realise that they are responsible for internal controls. Currently, this is one of the major stumbling blocks”*. By focussing on these acute shortcomings, internal auditors have great opportunities to demonstrate their value in the short run by enhancing the level of formalisation, standardisation, transparency and documentation. Their attention to the link between risks and internal controls makes them an important player in risk management. Especially in those Belgian cases without a formalised and standardised risk management system, risk and internal control communication is a crucial aspect of internal auditors' pioneering role.

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<sup>13</sup> A first draft of the Belgian Code on Corporate governance, the so-called Code Lippens, was published on the 18<sup>th</sup> of June 2004. After a successful public consultation period, the final version was published on the 9<sup>th</sup> of December 2004. The full text of this Code can be found at: <http://www.commissiecorporategovernance.be>.

Table 2 summarises the general and country specific roles of internal auditors in risk assessment, risk management and risk and internal control communication:

[INSERT TABLE 1 HERE]

The final section of this paper summarises the most important conclusions, discusses the implications of our results for the internal audit profession, mentions some limitations of this study and ends with suggesting interesting topics for future research in this area.

## **CONCLUSION AND DISCUSSION**

In this qualitative study, we found that the specific content of internal auditors' role in risk management is time specific and changes quickly. It is important to see that constantly emerging changes in the business environment are an important basis for the role of internal auditors in risk management. It should be noted that the conclusions of this study are not linked neither with the size of the company nor with the size of the internal audit function.

In both Belgian and US companies, internal auditors' role in risk assessments can be considered as an important input for their global audit planning and individual audits. It becomes clear that an evolution towards a higher level of risk based auditing is absolutely needed if internal auditors want to play an important role in risk management. All our cases illustrate that the review and appraisal of the effectiveness and efficiency of the internal control system (including compliance audits) in order to provide an independent opinion on it, remain the major assurance task of internal auditors. Recommendations on further improvements of the internal control system are an integral and valuable part of this assurance role. Moreover, internal auditors are often involved in the development and facilitation of self-assessments as well as the development and improvement of internal controls. By spreading 'best practices', internal auditors have a crucial benchmarking role for risk assessment and internal control practices. It becomes clear that the input (centralised risk databases) as well as the output (annual and quarterly reports on risk and internal controls) of their assurance role fulfil an important communication role in the risk management system. Additionally, the output of certain consulting activities (e.g. internal control manuals, risk and control questionnaires, training) also contributes to an efficient risk and internal control communication.

Besides these general insights, we found that the role of internal auditors in the US cases, now strongly influenced by the new internal control review and disclosure requirements mentioned in the SOX Act, is different from their role in the Belgian cases. For this last group, internal auditors' focus on acute shortcomings in the risk management system creates great opportunities to demonstrate their value in the short run.

In the US cases, the objective evaluations and opinions on the internal control system provided by internal auditors are a crucial and valuable input for the internal control disclosures made by the CEO, CFO and management. Moreover, we see in the US cases an evolution towards more internal audits focused on financial controls and controls related to financial reporting. Internal auditors' consulting role in risk management is now mainly oriented towards a further improvement of the transparency and documentation of the risk management process. This last aspect is considered as a significant contribution to the compliance with new disclosure requirements.

For the Belgian cases, internal auditors are playing a proactive role in the preparation for similar internal control disclosures in the (near) future. In only half of the Belgian cases, we see an enhanced attention to financial controls and controls related to financial reporting. Their consulting role in risk management can be linked with the global stage of development of the risk management system. By being proactively involved in internal control development and improvement, internal auditors are playing an important pioneering role in the creation of a higher level of control awareness and a (more) formalised, standardised, transparent and documented risk management system.

Based on the expectations of our interviewees, we can conclude that, within the Belgian context, the internal auditing profession is actually in a kind of "transition phase". During the last years, internal auditors have expanded their range of (especially consulting) services in order to demonstrate their added value to the organisation and to make their function become accepted. Following their American colleagues, Belgian internal auditors should, within a reasonable time period, focus more on their core activity. The current state in Belgium, however, is still quite different from the situation of their American counterparts.

As clearly illustrated above, internal auditors' role in risk management is strongly linked with the development stage of the risk management system. It should be clear that top

management has to become aware of the usefulness of a formalised risk management system and their specific responsibilities in risk management. Top management has to give the right signals to the lower management levels (top-down approach) in order to convince them of their operational responsibilities related to for example the development and implementation of internal controls. When internal auditors want to survive this “transition phase”, they need to assume a kind of “teaching role” vis-à-vis the different management levels, which necessitates well-developed presentation skills, a sufficient dose of persuasiveness and an open dialogue. Internal auditors have to demonstrate the potential and specific consequences (financial, reputation,...) for the organisation of not having a proactive and formalised risk management system, which should normally rouse top management.

As soon as all management levels take their responsibility, risk management systems will certainly become more formalised. Based on current observations, we can predict that Belgian internal auditors will be able to re-distribute their audit planning towards the provision of an independent and objective opinion on the state of risk management system as a whole and the internal control system more specifically and prepare themselves for disclosure requirements, similar to their American colleagues. We are convinced that Belgian internal auditors will benefit from this “transition phase” in a way that will make their profession become more mature and accepted.

Given the qualitative nature of this study and the limited number of companies, it is important to take into account that generalisation of the results to all Belgian and US companies is not possible. With respect to the second group, further research could collect data within US parent companies or within subsidiaries of these US companies in other (European) countries in order to validate these conclusions. Although this study gives a good impression of the specific role of internal auditors in risk management and the marked differences between both groups of companies, a large scale test of these findings will be an interesting future research activity. When doing this, diverse sub-samples can be made by controlling certain variables suggested in this study. It can reveal interesting new findings when making a comparison between for example large, well-sourced internal audit departments and small audit shops with limited resources.

The time specific character of these results can be considered as a (logical) limitation of this study. As mentioned before, the content of internal auditors’ role in risk management,

influenced by a constantly evolving business environment and regulations, changes regularly. This creates unique opportunities to conduct longitudinal research on how their role changes overtime. In a specific Belgian context, it will be very interesting to see how further revisions of the Belgian Code on Corporate Governance will impact the internal audit profession.

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**Table 1: Overview of the Role of Internal Auditors in Risk Management**

<p><b>General Insights</b></p>	<ul style="list-style-type: none"> <li>- Their role in risk management is time specific and changes quickly;</li> <li>- Changes in the business environment are an important basis for their role in risk management;</li> <li>- Internal auditors are concerned about their capacities to play an important role in risk management (quality or satisfaction surveys);</li> <li>- Consulting activities are more focused on internal controls instead of a general business focus in the past;</li> </ul> <p><i><u>Risk assessment</u></i></p> <ul style="list-style-type: none"> <li>- Limited involvement in risk assessments (integration role);</li> <li>- Risk assessments are an important input for the evaluation of the internal control system;</li> <li>- Limited consulting role in risk assessment (facilitation of risk-self-assessments);</li> </ul> <p><i><u>Risk management</u></i></p> <ul style="list-style-type: none"> <li>- Provision of an independent and objective evaluation of the internal control system remains their major assurance task (including recommendations);</li> <li>- Involvement in the development and facilitation of control-self-assessments;</li> <li>- (Pro-active) involvement in internal control development and improvement;</li> </ul> <p><i><u>Risk and control communication</u></i></p> <ul style="list-style-type: none"> <li>- Crucial role in the spread of best practices;</li> <li>- Benchmarking source;</li> <li>- Development and maintenance of a centralised risk database;</li> <li>- Spread of reports on risks and internal controls;</li> <li>- Spread of internal control manuals;</li> <li>- Spread of risk and control questionnaires for self-assessments.</li> </ul>
<p><b>US Cases</b> (established corporate governance context)</p>	<p><i><u>Risk management</u></i></p> <ul style="list-style-type: none"> <li>- Assurance role strongly focused on the provision of a global overview and opinion on the state of internal control (input for disclosures);</li> <li>- Consulting role oriented towards a further improvement of transparency and documentation on risks and internal controls (input for disclosures);</li> <li>- General evolution towards more internal audits on financial controls and controls related to financial reporting.</li> </ul>
<p><b>Belgian Cases</b> (emerging corporate governance context)</p>	<ul style="list-style-type: none"> <li>- Small audit shops: limited resources are an important constraint for their role in risk management;</li> </ul> <p><i><u>Risk management</u></i></p> <ul style="list-style-type: none"> <li>- Proactive role in the preparation for internal control disclosures in the (near) future (sporadic overall assessments and reports);</li> <li>- Partial evolution towards more internal audits on financial controls and controls related to financial reporting;</li> <li>- Valuable pioneering role in the evolution towards a formal, standardised, transparent and well documented risk management system (creation of risk and control awareness).</li> </ul>







**PAPER 4**  
**INTERNAL AUDIT: THE EXPERT IN PROVIDING COMFORT**  
**TO THE AUDIT COMMITTEE**  
**THE CASE OF RISK MANAGEMENT AND INTERNAL CONTROL**

Paper four refers to the second research question of this dissertation by studying the influence of one stakeholder of internal audit, namely the audit committee, on internal audit practices (micro level). Complementary to existing research in this area, this paper applies a unique theoretical perspective to create new insights on this relationship. The in-depth insights of this paper complement the more general indications elaborated in paper two as well as the internal auditors' perceptions studied in paper three. In paper five, senior management's expectations and perceptions will also be taken into account.





**INTERNAL AUDIT: THE EXPERT IN PROVIDING COMFORT  
TO THE AUDIT COMMITTEE.  
THE CASE OF RISK MANAGEMENT AND INTERNAL CONTROL<sup>14</sup>**

**Gerrit Sarens**

**Ignace De Beelde**

**Abstract:** This study investigates to what extent audit committees feel uncomfortable about risk management and internal control, and focuses on how internal audit can be the expert in providing comfort in these areas, building upon the sociology of professions literature. Four case studies reveal that audit committees need comfort with respect to the control environment. Thanks to their internal position, their familiarity with the company, and their position close to people across the company, internal audit seems to be the most suitable one to provide comfort and be the ‘guard of the corporate culture’. Furthermore, audit committees need comfort regarding the internal controls in high-risk areas. Besides internal audit’s assurance role, active involvement in the improvement of these internal controls provides a significant level of comfort to the audit committee. Their unique conceptual and company-specific knowledge about risk management and internal control, combined with the right inter-personal skills, enables internal audit to provide this comfort. Formal audit reports and presentations, together with informal contacts, seem to be important ways of providing this comfort. Finally, it becomes clear that the overall level of comfort in the audit committee can be enhanced through a ‘joint audit approach’ between internal and external audit.

**Keywords:** internal audit, audit committee, risk management, internal control, comfort, expert, sociology of professions, case studies

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## INTRODUCTION

Audit committees have a growing monitoring role in corporate governance. *Article 39* of the proposed *Directive on Statutory Audit*, published by the *European Commission* in 2004, stipulates that the audit committee shall monitor the financial reporting process, the effectiveness of the company's internal controls, its internal audit where applicable, and its risk management systems. Moreover, the audit committee shall oversee the statutory audit, and monitor the independence of the statutory auditor or audit firm.

However, audit committee members, in most cases non-executive directors, are confronted with an important information asymmetry problem (Raghunandan et al., 1998; 2001). More specifically, they often lack information on the status of the organisation-specific risk management and internal control system, resulting in uncertainty. This uncertainty creates a certain level of discomfort among the audit committee members (cf. Pentland, 1993).

Previous research in this area argues that this information asymmetry between audit committees and management is more likely to be reduced when there are high-quality interactions between audit committees and internal audit (Raghunandan et al., 1998, 2001), without going deeper into the meaning of this so-called 'high-quality' interaction. These authors only mention that regular meetings between the audit committee and internal audit make it more likely that the audit committee remains informed and knowledgeable about relevant accounting and auditing issues. The currently-presented study goes further and investigates to what extent uncertainty and discomfort encourage audit committees to look for internal audit support, especially with respect to risk management and internal control (Pentland, 1993). Furthermore, we will focus on how internal audit can be the primary source of comfort for the audit committee with respect to risk management and internal control, thereby building upon the sociology of professions literature (Abbott, 1988; Reed, 1996).

Most empirical research on audit committee effectiveness, applying a so-called '*black box approach*', deals with the impact of audit committees (their existence and externally-observable characteristics) on specific aspects of governance, by relying on several proxies (cf. Abbott et al., 2000; Beasley, 1996; Beasley et al., 2000; Dechow et al., 1996; DeFond and DeZoort and Salterio, 2001; Jiambalvo, 1991; McMullen, 1996; Raghunandan et al., 2001) and ignores the processes associated with audit committee operation, of which the

relationship with internal audit is part. However, Spira (2003) and Turley and Zaman (2004) clearly express the need for explicit theorization of the *processes* associated with audit committee operation and, thereby, for opening the audit committee ‘black box’. This study, investigating the relationship between internal audit and the audit committee, focuses more on the *audit committee process* (Gendron *et al.*, 2004; Gendron and Bédard, 2006) instead of the relationship between audit committee input and output. Furthermore, this study complements the existing, mainly quantitative literature in this area, by analysing qualitative empirical data (interviews and documents) derived from four case studies involving Belgian companies.

This paper is structured as follows. The next section presents an outline of the broader institutional context of this study. The third section delves deeper into the theoretical underpinnings of this study, followed by presentation of the research questions. The fourth section deals with the methodology used in this study, followed by a fifth section, in which the empirical material is analyzed. The paper ends with conclusions and a discussion.

## **INSTITUTIONAL CONTEXT**

Audit committees have received considerable attention following both more distant and more recent corporate scandals. Early recommendations, in Anglo-Saxon countries, for the voluntary adoption of audit committees were followed by proposals to extend their use to many other countries (Collier and Zaman, 2005). The European Commission has been active in promoting the audit committee concept within its briefs, in attempts to create a fair internal market. Audit committees are expected to have a key role in ensuring the high standards in financial reporting that underpin confidence in financial markets (European Commission, 2003).

Stakeholders of organisations increasingly are demanding that boards and executive management apply accepted governance principles, adhere to sound risk management, and demonstrate publicly that they are in control of their organisation. Likewise, we see more effective internal control as contributing to, rather than being a drain upon, the bottom line (Chambers, 2005; ECIIA, 2005). Several corporate governance guidelines, including the Belgian Code on Corporate Governance (2004), clearly stipulate the board’s monitoring responsibilities with respect to the system of risk management and internal control. This

monitoring responsibility often is delegated to the audit committee, who will advise the board on the effectiveness of risk management and internal control.

Principle five of the Belgian Code on Corporate Governance (2004) deals with the audit committee's responsibilities, and clearly *recommends* that:

- At least once a year, the audit committee should review the internal control and risk management systems set up by executive management, with a view to ensuring that the main risks are properly identified, managed and disclosed;
- The audit committee should review the statements included in the annual report on internal control and risk management; and
- The audit committee should review the specific arrangements made, by which staff of the company may, in confidence, raise concerns about possible improprieties in financial reporting or other matters. If deemed necessary, arrangements should be made for proportionate and independent investigation of such matters, for appropriate follow-up action and arrangements, whereby staff can inform the chairman of the audit committee directly.

As is the case with corporate governance mechanisms in general, recommendations and regulations related to audit committee responsibilities differ between countries and institutional settings. Overall, in Europe, audit committee formation and practices typically are less regulated, even for listed companies. In the US, the *Securities and Exchange Commission* (SEC) and the stock exchange have issued rules with respect to audit committee composition and practices that are mandatory requirements.

It should be clear that risk management and internal control are essential parts of corporate governance. Given internal audit's focus on risk management and internal controls, it is likely that internal audit becomes an important player in corporate governance, and that companies become more aware of the benefits of internal auditing (Carcello et al., 2005; Chambers, 2005). This can be seen from the growing number of internal auditors in Europe, who now can be found in all sectors (ECIIA, 2005).

The *Institute of Internal Auditors* (IIA) also plays an important role in the promotion of internal audit as a crucial player in corporate governance. The most significant illustration of this was the publication of the new internal audit definition (1999), clearly describing internal

audit as an activity that “*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.*” Moreover, a significant portion of the *International Standards for the Professional Practice of Internal Auditing* (2004) clearly refers to the role of internal audit in risk management, internal control and governance. In other words, an internal auditor whose activity fulfils the definition and complies with the Standards is in a strong position to support the board (and audit committee) as an essential component of their governance mechanisms (ECIIA, 2005).

### **THEORETICAL UNDERPINNINGS**

Recent studies by Gendron et al. (2004) and Gendron and Bédard (2006) show that practices carried out in audit committee meetings aim to make members comfortable with regards to matters such as the accuracy of financial statements and the quality of the work performed by internal and external auditors. They argue that the notion of *comfort*, as introduced in Pentland’s study (1993) on audit engagements, also is a fundamental aspect of the work performed by audit committee members. Their analysis shows that managers and auditors need to demonstrate to audit committee members that they are *trustworthy*. Consequently, meetings in ‘effective’ audit committees may be conceived of as being arenas wherein attendees establish and secure their reputation of *trustworthiness*. Likewise, Spira (1999), building upon *actor-network theory*, argues that the ceremonial components of audit committee meetings play an important part in offering comfort and reassurance to investors and lenders.

Audit committee members in the study by Gendron et al. (2004) had an interest in the extent to which internal control is effective, not least because internal control underlies the credibility of financial reports. Audit committee members are convinced that, to fulfil their responsibilities, they are dependent upon the quality of the work performed by the company’s internal and external auditors. Gendron and Bédard (2006) found that audit committee members carry out diverse practices, in order to become comfortable with their company’s internal controls, and that several of these practices deal with reports from internal audit. They especially rely on the work of internal audit to develop their own appreciation of the controls’ effectiveness (cf. also Krishnan, 2005).

This argument is an interesting starting point to further elaborate on the specific relationship between the audit committee and internal audit. We now will go into more specific detail about how internal audit can be a trustworthy provider of comfort with respect to risk management and internal control.

### **Uncertainty and the Need for Comfort**

Pentland (1993) argues that a world without accounting or auditing would no doubt create a sense of *discomfort*. The relative absence of this feeling in the normal conduct of affairs demonstrates how effectively the audit ritual generally has succeeded in transforming chaos into order. Substantially, auditors are centrally implicated in the social production of trust in financial markets. Auditors give '*comfort*' to people who are vulnerable to erroneous, self-interested, or possibly fraudulent statements from corporate management. Although Pentland (1993) mainly focuses on external (financial) auditors as providers of comfort, a similar argument can be made for internal auditors.

According to Pentland (1993), '*purification*' is a central function of the audit ritual. Moore and Myerhoff (1977) frame the concept of purification in terms of the difference between order and chaos, between form and indeterminacy. Given the complexity of organisations, we can argue that the indeterminacy and vagueness of most risk management and internal control systems comprise a fundamental issue for audit committee members. In other words, this makes audit committee members feel *uncomfortable*, especially given their increased monitoring responsibilities in these areas. Therefore, we expect the process of purification to have considerable significance in internal audit work. Similar to Pentland's arguments (1993), internal audit work makes audit committee members feel '*comfortable*' by transforming and purifying inherently vague and unclear risk management and internal control data. More recently, Spira and Page (2003) found that internal auditors have been exhorted to present themselves as risk management *experts*, basing this expertise on their familiarity with internal control processes. However, they argue that the extent to which this aspiration has been achieved, in practical terms, remains unclear.

Power (1997) argues that '*symbols of comfort*' only have value if they are produced by a credible and independent authority. Based on Pentland's reasoning (1993), we can argue that only those considered to be *professional internal auditors* can be *trusted* to perform internal audit work and create the necessary '*symbols of comfort*'. In order to build arguments why

internal auditors may be considered the most suitable experts to provide audit committee members with comfort on risk management and internal control topics, we refer to arguments used in the *sociology of professions* literature.

### **Internal Audit as a Trustworthy Expert Provider of Comfort**

The sociology of professions literature has reasoned that the key to survival and the claim of professional stature is the development and maintenance of an abstract system of knowledge, because it is from this knowledge base that a profession establishes its jurisdiction. Thereby, this literature increasingly has focused on inter and intra-professional competition, while socially constituting a jurisdiction by controlling an abstract system of knowledge (Abbott, 1988). This basically means that one professional occupation, such as internal audit cannot be studied in isolation from other occupations, such as external audit (Covaleski et al., 2003; Rittenberg and Covaleski, 2001).

In the context of internal audit, the abstract system of knowledge largely refers to organisation-specific knowledge on risk management and internal control. It is via this control that a profession can (1) define and redefine the problems it addresses; (2) develop the services and practical techniques that must be performed to address these problems (that Abbott defines as the profession's jurisdiction); and (3) defend this resultant jurisdiction against competing professions or factions within the profession. Abbott (1988) defines 'jurisdictional domains' as areas of task performance in which expert groups make 'more-or-less' exclusive claims to technical, social and cultural authority over the knowledge and skill that falls within their ambit. Thus, the evaluation and improvement of risk management and internal control can be considered an important 'jurisdictional domain' of internal audit. Moreover, in this context, external audit can be considered to be a competing profession, as external auditors also can claim to possess relevant information on risk management and internal control systems, based upon their work carried out in the context of financial audits.

Cooper (1992) argues that experts become the crucial social groups for mediating radical doubt and uncertainty, and that they establish some degree of collective trust and stability - in other words, 'comfort' - in highly mobile societies. Several studies that have analysed expert power and control in late modernity highlight the strategic contribution that experts and expertise make to the much more sophisticated and pervasive systems of organizational surveillance and control that have been crystallizing in (post) modern societies. This



argument can be transferred to the context of this study, by considering internal auditors to be the experts in risk management and internal control who are crucial to establishing trust and stability (or comfort, using Pentland's terminology) for audit committee members. This expertise will enable audit committees to fulfil their growing monitoring responsibilities in corporate governance.

Relying on the sociology of professions, Reed (1996) defines three expert groups: (1) independent or liberal professionals; (2) organisational professionals; and (3) knowledge workers. Covalleski et al. (2003) classify internal auditors as organisational professionals and external auditors as knowledge workers. According to Reed (1996), the organizational profession's basic power strategy and corresponding legitimating discourse lie in obtaining and displaying appropriate credentials that support the individual practitioner's claim to esoteric knowledge. In the context of internal auditors, these credentials may be interpreted as professional recognitions, such as the Certified Internal Auditor (CIA) certificate, as well as overall professional expertise in areas related to risk management and internal control. The second legitimating discourse lies in developing a knowledge base and repertoire of skills that are specific to serving the particular organization within which the professional is housed (Abbott, 1988). The knowledge and skills of internal auditors relate to organisation-specific risk management and internal control topics.

As Reed (1996; 576) reasoned, "it is the putative universality, codifiability, neutrality and mobility of modern, entrepreneurial expertise that sets it apart from the localism, particularism and stability characteristic of traditional, organizational expertise." This last quote illustrates an important difference between external and internal audit: the knowledge of external auditors is universal, neutral and transferable to all client companies; whereas the knowledge of internal auditors is highly organisation-specific and less transferable to other organisations.

Within the internal audit literature, Rittenberg and Covalleski (2001) draw from the sociology of professions literature to examine the clash between the public accounting profession and the internal audit profession over the provision of internal audit services. A common theme in the in-house efforts to retain the provision of internal audit services is the attempt to reaffirm the boundaries of the external and internal audits, thus claiming exclusive rights to control specific work activities (cf. Abbott, 1988; Reed, 1996).

Furthermore, Covalleski et al. (2003) use the sociology of professions' perspective to examine the dramaturgy of exchange relations among the Big Five public accounting firms, as well as the AICPA, the IIA, and the SEC in the context of the outsourcing of internal audit services to international external audit firms. They refer to the *Foreign Corrupt Practices Act* (1978), an act that underscored, for the first time, the importance of *localised knowledge* that is brought to bear by the internal auditor: "reviewing, monitoring, and evaluating the system of internal accounting control require a great deal of *familiarity* with the company and understanding of its potential exposures and related controls (Clarence Sampson, SEC Chief Accountant, 1979)." Furthermore, in the debate on outsourcing internal audit services, the IIA (1994) claimed that internal auditors are intimately acquainted with their organisations' policies, procedures, operating practices and personnel. Through *day-to-day experience* in the business, internal auditors acquire an *intimate knowledge* of an organization's culture, processes, risks and controls, and thereby obtain the 'proprietary knowledge' that figures prominently in providing management and audit committees with tailored and relevant information on risk management and internal controls.

### **Research Questions**

The aim of this study is to develop a better understanding of the specific relationship between internal audit and audit committee, particularly within the context of risk management and internal control, applying the theoretical concepts described above. Two research questions guide the analysis of our empirical materials:

1. To what extent do audit committees need comfort relating to risk management and internal control?
2. How can internal audit be an expert, providing comfort to the audit committee about risk management and internal control?

## **METHODOLOGY**

### **Why do we Rely on Qualitative Research?**

The majority of previous research on audit committees and internal audit has been based on large samples using archival and survey data that mainly rely on proxies and externally-observable characteristics. However, Spira (1999) argues that "there is a dearth of studies which explore the perceptions of those involved in audit committee activity, through the use of qualitative research methodologies." Moreover, Turley and Zaman (2004) also advocate

field studies to complement extant research. Qualitative data, including in-depth interviews combined with relevant internal documents, provide a significant potential for researching the relationship between the audit committee and internal audit in their organisational context (cf. Patton, 2002).

While large-sample studies provide a generalizable set of findings pertaining to a few pre-determined constructs, in-depth case studies produce much more detailed information, but about a limited number of people and cases (Patton, 2002). In this study, we focus on understand-ability and theory specification (Keating, 1995), given the limited amount of in-depth knowledge that exists on the relationship between audit committees and internal audit. It is important to see that the status of the risk management and internal control system, the broader context in which this relationship is studied, is, to a large extent, company-specific (Covaleski et al., 2003) and cannot be generalised across all Belgian companies (Sarens and De Beelde, 2006a). Consequently, the needs of the audit committee for comfort, and the specific ways by which internal audit can provide that comfort, also are company-specific and, thus, must be studied from a holistic perspective (Patton, 2002) using in-depth company-specific data gathered via case studies.

#### **Four Case Studies**

The selection of the four companies (cases) for this study was partially theoretically-driven (Glaser and Strauss, 1967) and partially based upon experience with the internal audit profession in Belgium. Based upon previous research (Chow, 1982), we controlled for firm size and selected companies with at least 1,000 employees. All four companies operate on an international scale (Europe, US, Asia and Middle East). Three companies (cases B, C and D) are listed on Euronext Brussels, and two companies (cases A and B) are controlled by a family. Previous research on internal audit within a Belgian context (Sarens and De Beelde, 2006a; 2006b) indicated two interesting parameters to control for: (1) the age of the internal audit function; and (2) the number of internal auditors. Related to the first parameter, we included three companies with a mature internal audit function (having existed for more than five years) and one company that more recently has created an internal audit function (having existed for less than five years). Related to the second parameter, we selected three companies with a small internal audit department (less than five internal auditors) and one company with a larger internal audit department (more than five internal auditors). Table 1 presents an overview of the four cases.

[INSERT TABLE 1 HERE]

**Case B**, a service company, represents the smallest participant in this study, with annual revenues of less than 500 million Euro. In this company, the internal audit function was created more than 15 years ago, and currently is represented by a single internal auditor. In **Case C**, a manufacturing company with annual revenues between 500 million and 1 billion Euro, the internal audit function was created 16 years ago. However, the internal audit function always has been performed by a single internal auditor. The two other companies have annual revenues of more than 1 billion Euro; Case D is particularly large, having more than 10 000 employees. In **Case A**, a service company, the internal audit function recently was created and is represented by one internal auditor. In **Case D**, a manufacturing company, the internal audit department has existed for more than 20 years, and consists of 10 internal auditors.

With respect to the audit committee, Table 2 provides, for each company, the number of audit committee members, non-executive audit committee members, independent audit committee members and audit committee meetings.

[INSERT TABLE 2 HERE]

### **Data Collection**

For each case, we conducted in-depth interviews with the internal auditor (Cases A, B and C) or the Chief Audit Executive (Case D) and the head of the audit committee. The interviews, taking place from June through September 2005, lasted from 60 to 120 minutes. We took several steps to increase the reliability of the collected data. We started each interview by describing the objectives of our study. We regularly asked interviewees to provide specific examples to substantiate their thoughts. Furthermore, all interviews were tape-recorded and transcribed immediately after the interview. Complete anonymity and the guarantee that no other organisation member would examine the transcript were provided. Finally, interviewees had the opportunity to verify the accuracy of the transcript and add changes, if they deemed this necessary, within one week of the interview (cf. Patton, 2002).

In order to support the interview data and enhance the reliability of our conclusions, we obtained copies of several archival materials, like the internal audit charter and internal audit

plans, as well as even more confidential documents like internal audit reports, internal presentations, business control guides, audit committee reports, and so on. Furthermore, we transcribed many field notes, containing all kinds of impressions, comments and anecdotes written down during or immediately after interviews.

### **Data Analysis**

A key step in analysing data from case studies is *within-case analysis*, which helps us to cope with the deluge of data that springs from field work. As suggested by the analytical protocol of Miles and Huberman (1994), all interview transcripts, archival documents and field notes were coded. Then we performed detailed case study write-ups, using standardised matrices, for each company. This process allowed the unique patterns among the relationship between the audit committee and internal audit within each case to emerge before we generalised patterns across cases. The *cross-case analysis* we performed in the next step forced us to go beyond initial impressions, and it enhanced the probability that we would capture the novel findings which exist in the data.

Each of the four cases offers different insights into the notions of seeking and providing comfort. Therefore, we will describe the major insights of each case individually, before moving on to any formulation of cross-case insights.

## **EMPIRICAL RESULTS: WITHIN-CASE ANALYSIS**

### **Case A**

#### ***Overall Status of the Risk Management and Internal Control System***

The interviews, as well as the document analysis, reveal that the overall risk management system is not well-developed within this company. The company has a rather informal and passive way of dealing with risks, lacking any established risk management strategy. The control environment can be described as ‘soft’, whereby top management sometimes gives the wrong signals to lower management levels, thereby encouraging unethical behaviour.

#### ***Audit Committee Seeks Comfort***

The major source of discomfort or uncertainty for the audit committee can be found in some serious problems that emerged after a recent acquisition within another European country.

For the audit committee, these problems clearly illustrated the weaknesses of not having a formal and well-developed risk management system. These feelings of discomfort made the audit committee more aware of the importance of risk management; for example, as a crucial decision-supporting tool in cases of mergers and acquisitions.

When evaluating the different sources of comfort, the audit committee perceives the external auditor as being too superficial, and not able to provide thorough control of operational aspects:

“What strikes me is that the results of the external audit work were not consistent with the problems we discovered afterwards. I think their controls were too much focused on financial aspects, whereas most of the problems we discovered were at the operational level [head of the audit committee].”

It seems that the universal, neutral and easy-transferable character of an external auditor’s knowledge (cf. Reed, 1996) does not provide sufficient comfort to the audit committee in this company. The audit committee clearly perceives the internal auditor as being more able to exercise thorough control on the company, and thus more able to provide the necessary comfort, due to his internal position, his familiarity with the company and its operations, and his position close to the people on the floor (cf. Covaleski et al., 2003). Therefore, the audit committee expects the internal auditor to make them feel more comfortable by playing an important communicator or translator role between the operational and monitoring levels.

Overall, the audit committee is aware of the need for internal audit support in acquiring the necessary information from within the company, which enables the audit committee to fulfil its responsibilities:

“We do not have enough contact with the field, as we call it, and that is what we really need to do our job. Therefore, we need good interaction with the internal auditor [head of the audit committee].”

More specifically, the audit committee seeks comfort in a limited number of specific, high-risk areas. The audit committee is convinced that the internal auditor’s specific knowledge and expertise makes it possible for him to focus his control work on a limited number of high-risk areas, and give a limited number of specific recommendations to improve the internal controls in these areas. A risk-based way of auditing seems to be a good way for the internal

auditor to provide comfort to the audit committee. Given the overall status of the risk management and internal control system, and the averse attitude of management towards risk management, close follow-up on and even facilitation of the implementation of his recommendations would provide additional comfort to the audit committee. By communicating with respect to the follow-up of his audits, and showing how the risk management and internal control systems are improving, the internal auditor will be able to provide valuable information, enabling the audit committee to formulate its own opinions and fulfil its monitoring responsibilities. Furthermore, the audit committee wants to receive this information by means of short and focused audit reports.

### ***Internal Auditor Provides Comfort***

The internal auditor clearly indicated different ways to create a sense of comfort amid the audit committee, given the status of the risk management and internal control system. Overall, the internal auditor is convinced that he has to apply his knowledge and expertise by playing an active role in risk management. His most important role is creating risk and control awareness on behalf of management. In other words, providing the right signals and illustrating the importance of risk management and internal controls is the first step in the process of change that this company must adopt.

More specifically, an important source of comfort results from the fact that the internal auditor is able ‘to make things happen’; in other words, from internal auditor-prompted discussions on risk management and internal control, increased awareness and appropriate control actions emerged in different layers of the company. Furthermore, this discussion resulted in a number of projects aiming to document the internal control system and develop procedures. In the words of the internal auditor:

“Currently, I am like a challenger, a driver of innovation, a driver of change management [internal auditor].”

Moreover, the internal auditor also intends to actively contribute to the formalisation of the risk management process, and to the evaluation of a new control strategy, a function which is confirmed by the internal audit charter.

Besides his active role in formalising the risk management and internal control system, the internal auditor considers it his mission to educate the audit committee members about frameworks like COSO and ERM:

“They do not know frameworks like COSO and ERM, so I will have to introduce these concepts to them, step by step. Recently, I illustrated to them the meaning of ‘tone at the top’, as this is a major risk area for the company [internal auditor].”

Although the audit committee is aware of the importance of risk management and internal control, this education role will make its members more comfortable with the theoretical underpinnings.

It becomes clear that the internal auditor’s abstract knowledge base, on which he claims to be an expert provider of comfort, consists of his general conceptual knowledge, as well as his more specific practical knowledge of risk management and internal control. It is important to see that this knowledge and expertise primarily is based upon his prior work experience (in the financial sector and as an external auditor). Furthermore, being resolute and persuasive are important interpersonal skills to create risk and control awareness and to drive the formalisation of the risk management and internal control system. In other words, besides an abstract system of knowledge, interpersonal skills are crucial to becoming an expert provider of comfort (cf. Abbott, 1988; Cooper, 1992; Reed, 1996).

As he is the only internal auditor in the company, he is aware of his limitations with respect to providing comfort to the audit committee. Therefore, he has started to collaborate actively with the external auditor, as both are convinced that they have the same goal, namely, creating risk and control awareness and assisting with the formalisation of a risk management system. By combining their knowledge and expertise, this collaboration can enhance the overall level of comfort within the audit committee, and can be considered the opposite of the ‘inter-professional competition’ suggested by Abbott (1988). Despite their different knowledge bases and power strategies (cf. Covalleski et al., 2003; Reed, 1996), this case illustrates that the jurisdictional domain of risk management and internal control is, to some extent, shared by the internal and external auditor, which makes a ‘joint audit approach’ easier and even desirable.



## Case B

### *Overall Status of the Risk Management and Internal Control System*

Both the head of the audit committee and the internal auditor described the risk management system as rather informal. The head of the audit committee makes the link between the trust-based corporate culture, which requires less formal risk management and fewer internal controls, and the family-dominated shareholder structure. The internal auditor concludes that a good balance exists between formal and informal internal controls within the company. Essential internal controls exist that are adopted to address the major potential risks.

### *Audit Committee Seeks Comfort*

The head of the audit committee clearly indicates that the audit committee almost exclusively focuses on financial results and financial reporting issues. With respect to internal control, the members mainly are concerned with financial controls, as they provide assurance on the correctness of the financial figures. In other words, their major information asymmetry (cf. Raghunandan et al., 1998, 2001) lies within financial aspects and financial controls, two areas in which they feel uncertainty and discomfort (cf. Pentland, 1993). Consequently, the audit committee perceives the external auditor as being its major potential source of comfort in these areas. It appears that the audit committee is not convinced of the potential role of the internal auditor in providing them with comfort related to internal controls, especially because the members do not perceive him as independent:

“The internal auditor is working for management and is strongly influenced by management, so there is still an independence problem. We rely on the external auditor. He is the only source of neutral information on the internal control system [head of the audit committee].”

Nevertheless, based upon information received from the external auditor, the audit committee wants to provide input to the internal auditor, so that he can investigate specific issues in more detail. Contrary to Case A, it seems that the audit committee is responsible for proposing a collaboration between the internal and external auditor. In other words, the audit committee attempts to combine these two sources of comfort. On one hand, the audit committee perceives the external auditor as being the expert responsible for reducing the audit committee member's major information asymmetry and, thus, providing them comfort (cf. Cooper, 1992; Reed, 1996). On the other hand, they want to involve the internal auditor, in order to provide

additional comfort on specific issues and, by doing so, to reduce the remaining information asymmetry. It seems like they are aware of the importance of localised knowledge and sufficient familiarity with the company in order to make more detailed investigations and, thus, provide comfort (cf. Reed, 1996; Covalesski *et al.*, 2003). Again, and similar to Case A, this illustrates that the inter-professional competition suggested by Abbott (1988) is less relevant in the context of risk management and internal control.

A more thorough investigation reveals that the relationship between the internal auditor and the audit committee is rather superficial in both directions. Currently, the audit committee perceives its role, vis-à-vis the internal auditor, purely as an overseer or monitor. Because the members do not perceive the internal auditor as a major source of comfort, their input to him is minimal. Similarly, it appears that the internal auditor provides a very limited amount of information to the audit committee. Important symbols of comfort, like internal audit planning and audit reports (cf. Moore and Myerhoff, 1977; Power, 1997), remain vague.

Even though the head of the audit committee, inspired by recent corporate governance guidelines, is convinced that risk management should become a major topic for the audit committee, the audit committee itself is not aware of its role in risk management. Consequently, the members do not feel discomfort or uncertainty in this area (cf. Pentland, 1993). They are convinced that risk management is an internal audit responsibility, but do not see how the internal auditor can provide comfort in this area:

“The internal auditor is dealing with risk management in a more formal way... but we do not know much about it. However, I do not feel that the audit committee members really need this information. Do we have to know it? [head of the audit committee]”

Nevertheless, he is convinced that, given the overall corporate culture, top management would not appreciate it if the audit committee deals too much with risk management in a formal way. Thus, without a change in the overall attitude towards risk management, it will be hard for the internal auditor to become perceived by the audit committee as an important provider of comfort in this area.

### ***Internal Auditor Provides Comfort***

Our data analysis reveals that the internal auditor’s relationship with the CEO is perceived as more important than his relationship with the audit committee. It appears that the internal

auditor is more a provider of comfort for management than for the audit committee. By indicating the major risks the company has, the CEO provides clear input for audit planning, which enables the internal auditor to focus his efforts on the CEO's major areas of concern. The CEO also provides feedback on the audit reports, indicating that these provide comfort to him.

Moreover, the internal auditor provided several examples illustrating how management appeals more and more to the internal auditor with specific concerns, problems and requests for evaluations of internal control or assistance with improvement of internal controls. This illustrates that, contrary to the audit committee, management perceives the internal auditor as an important source of comfort with respect to internal control, because of his expertise providing independent reviews and valuable suggestions for improvement (cf. Cooper, 1992; Reed, 1996).

Although the internal auditor seems to provide more comfort to management, he also wants to become a provider of comfort for the audit committee. Therefore, he expects the audit committee to give him specific input for his annual audit planning. By doing this, the audit committee can indicate its major areas of concern (uncertainty, discomfort); in other words, the areas in which the audit committee members want the internal auditor to provide comfort. Moreover, the internal auditor expects the audit committee to provide feedback on his audit reports, thereby indicating to him whether the members are satisfied with it; in other words, to what extent do these reports provide them with sufficient comfort? Although these are the clear intentions of the internal auditor, to date this has not occurred. The internal auditor confirms that the internal audit charter is an important tool for him to demonstrate the areas in which he can provide comfort. Nevertheless, it seems that the audit committee has not understood the charter's core message. Furthermore, an analysis of the audit reports indicates that they have the potential to become valuable symbols of comfort for the audit committee (cf. Moore and Myerhoff, 1977; Power, 1997). However, the audit committee only receives a summarised version of these audit reports.

The internal auditor is aware of the current intentions of management to start formalising risk management. Given his specific expertise as a former external auditor, the internal auditor plays an important role assisting management with this formalisation process:

“I am used to working in a formal and well-documented environment, so I can help them to formalise the risk management system [internal auditor].”

It is important to see that, if the audit committee becomes aware of its monitoring role in risk management and the importance of formalising risk management, this assisting role of the internal auditor can become a source of comfort for the audit committee members.

Furthermore, his experience as an external auditor creates opportunities for the internal auditor to formalise the collaboration with the external auditor that the audit committee is looking for as the ultimate source of comfort (cf. above). He indicates that this collaboration with the external auditor already exists, but in a rather informal way. Thus, demonstrating the results of this collaboration more formally to the audit committee would enable the internal auditor to become recognised by them as a provider of comfort. The internal audit charter clearly refers to this collaboration, stipulating that:

“The internal audit department will liaise with the external auditors to foster a cooperative working relationship, reduce the incidence of duplication of effort, ensure appropriate sharing of information, and ensure coordination of the overall audit effort [internal audit charter].”

## **Case C**

### ***Overall Status of the Risk Management and Internal Control System***

Although this company has an overall informal way of dealing with risks, the internal auditor is convinced that a certain level of risk awareness exists. Both the internal auditor and the head of the audit committee are advocates of a more formal way of managing risks, which is, according to them, a major challenge for the future. It seems like this formalisation process recently started with the performance of a company-wide risk assessment. According to the internal auditor, the internal control system largely is based on a kind of informal ‘common sense’, instead of being well-documented.

### ***Audit Committee Seeks Comfort***

In general, the audit committee works in a pro-active way, which means that the members strongly focus on high-risk areas that might create problems for the company in the future. This pro-active focus on high-risk areas creates a specific need for comfort on behalf of the audit committee (cf. Pentland, 1993). The audit committee is convinced that the internal

auditor is an important provider of comfort in certain of these high-risk areas and, therefore, clearly signals its need for comfort by giving specific input for his audit planning. The audit committee's focused interest in high-risk areas is reflected by the way the head of the audit committee deals with audit reports. Although the audit committee receives all audit reports, the members only read those audit reports that are related to these high-risk areas.

These audit reports clearly are considered to be working instruments for the audit committee, a fact which is confirmed by the numerous notes written on them by the head of the audit committee. Besides these formal symbols of comfort (cf. Power, 1997), the audit committee also has regular informal contacts with the internal auditor to discuss specific aspects of his work. These informal contacts are an important aspect of the relationship between the internal auditor and the audit committee (cf. Moore and Myerhoff, 1977), and represent an important way of providing comfort to the audit committee:

“If we have a question on an audit report, we often deal with this in an informal way by phone, so we do not always have to wait until the next audit committee meeting [head of the audit committee].”

The head of the audit committee illustrates the committee's way of working by describing some major high-risk areas that have created uncertainty and discomfort, and on which the committee currently is focussing (cf. Pentland, 1993). He also illustrates how the internal auditor has created comfort in these areas. For example, the possible emergence of fraud in the Asian subsidiaries is something about which the audit committee truly is worried. The fact that, as of now, the company does not have an answer for this problem, creates a significant feeling of discomfort and prompts the audit committee to ask the internal auditor to perform specific audits on the Asian subsidiaries. Another major issue of concern relates to receivables and stock issues. Over the past several years, the audit committee has asked the internal auditor to focus on these high-risk areas in order to provide them with some degree of comfort. An investigation into the audit planning confirms the influence of these high-risk areas on the working agenda of the internal auditor. As a result of the internal auditor's work in this area, management has initiated some important actions. The fact that the internal auditor was able to encourage management to take actions for improvement - in other words, that “the internal auditor can make things happen” - has created a sense of comfort within the audit committee.

Similar to Case A, the audit committee also seeks comfort regarding the control environment, as the basis for risk management and internal control. In other words, the ‘translator role’ of the internal auditor also is, in this case, appreciated by the audit committee as an important source of comfort about “what is going on in the company.” Furthermore, the internal auditor should be a facilitator for whistle-blowing, especially for people with a financial function. In order to play this ‘translator role’, it is very important for the internal auditor to have the right communication skills, as well as an open and friendly attitude towards others in the company.

### ***Internal Auditor Provides Comfort***

Given his limitations as a single internal auditor, he finds it hard to provide an opinion on the global status of the internal control system. Instead, he prefers to focus on reviewing the internal controls and recommending improvements in a limited number of high-risk areas, which clearly is reflected in his audit planning and audit reports. By doing this, he wants to provide assurance regarding the existence and effectiveness of the internal controls in these high-risk areas, especially because they have a direct impact on financial results. His major role corresponds with the philosophy of the audit committee and its specific needs for comfort. Furthermore, and if possible, the internal auditor attempts to improve the efficiency of the processes by providing additional recommendations.

In most instances, management is positive about his work and is interested in his suggestions to improve internal controls and processes, which have become important items at their business review meetings. The fact that management is reacting positively and wants to implement his suggestions gives a clear signal to the audit committee, a signal which is an important source of comfort for them:

“Things are improving, thanks to my work that has incited management to take action [internal auditor].”

Moreover, the internal auditor also finds it important to listen to others in the company and give them the chance to talk about problems or inefficiencies they encounter, in order to become aware of potential internal risks. It seems that he perceives the ‘translator role’ the audit committee wants him to play as inherent to the performance of his function.

Even though the internal auditor perceives the input of the audit committee as relatively limited, especially when compared with the input coming from management, he considers its input to be unconditional priorities. Because he is convinced that the major focus of the audit committee remains on financial results and reporting, the internal auditor clearly expresses his intentions to have his work receive more attention from the audit committee, by promoting himself as a credible and trustworthy provider of comfort with respect to risk management and internal controls (cf. Gendron *et al.*, 2004). Given some significant new risks for the company, like IT and fraud, both of which clearly are reflected as audit committee priorities, the internal auditor wants to focus his working agenda more on the provision of assurance with respect to internal controls in these high-risk areas. He clearly wants to highlight this assurance aspect in his audit reports, all of which are sent to the audit committee. Again, this illustrates the crucial role of audit reports as a symbol of comfort (cf. Moore and Myerhoff, 1977; Power, 1997). Additionally, the internal auditor is convinced that, as soon as the audit committee intends to provide a formal opinion on the status of the internal control system, its members will become even more interested in his work as a source of comfort.

Given his familiarity with the many divisions of the company and his intimate knowledge about the processes and internal controls (cf. Abbott, 1988; Reed, 1996), the internal auditor considers himself to be the most appropriate person to start formalising risk management. More specifically, he intends to play an important educational role for the audit committee, in order to make its members aware of the specificities of risk management and their own monitoring responsibilities. The internal auditor admits that, until now, he did not have the time to do this; but this will be an important challenge for him in the future. Given the fact that the audit committee already is convinced about the importance of formalising risk management, a more profound 'education' related to different aspects of risk management will be an important additional source of comfort for them.

## **Case D**

### ***Overall Status of the Risk Management and Internal Control System***

Contrary to the three previous companies, this company has a strong, formal, internally-developed risk management system. In order to follow-up on corporate evolutions, and taking into account the changing risks, the risk management system is updated yearly by top management, the audit committee and the head of internal audit. The company strives to

achieve a uniform corporate culture. Therefore, top management, together with the head of internal audit, have developed a uniform and standardised Code of Conduct and Guide to Business Control. This Guide to Business Control summarises all policies and procedures that the company has, at a group level, so as to enable and enforce business ethics and control. This guide also creates control awareness among all managers, and explains their specific responsibilities in each of the areas for which the company has developed internal controls and conduct rules.

### ***Audit Committee Seeks Comfort***

Generally, internal audit is considered by the audit committee to be a ‘business partner’. More specifically, the audit committee wants to become comfortable with respect to compliance with the overall company standards, as stipulated by the Code of Conduct and Guide to Business Control (cf. Pentland, 1993). Therefore, the audit committee members clearly expect internal audit to monitor compliance with this standard, and to make sure that all controls and standards are followed. By doing this, they provide a significant level of comfort to the audit committee. In other words, internal audit acting as ‘guard of the corporate culture’ creates the necessary comfort for the audit committee. It also is clearly mentioned in the company Guide to Business Control that company employees can contact internal audit to report a concern or breach of conduct rules. According to the head of the audit committee:

“It is comfortable to know that people can go to internal audit when they want to report a problem or concern [head of the audit committee].”

Moreover, the audit committee expects internal audit to play an important advisory and assistive role in the implementation of internal control improvements. Knowing that management can call on internal audit as a management tool actively contributing to the improvement of internal controls is a significant source of comfort for the audit committee. This philosophy also is clearly reflected in the Guide to Business Control. Until now, the audit committee feels comfortable with respect to this role.

The audit committee discusses, in an intensive way, the internal audit priorities and indicates its areas of discomfort and uncertainty (cf. Pentland, 1993) by adding new priorities to the



audit planning. During each audit committee meeting, the members also systematically discuss the audit results.

Besides formal interactions that occur during the audit committee meetings, the head of the audit committee has regular informal contacts with internal audit. He regularly meets one-to-one with the head of internal audit, and even attends internal audit team meetings as an informal observer. It seems like these informal interactions reveal valuable information for the audit committee and, consequently, are an important source of comfort for the audit committee.

Similar to Cases A and B, we found indications of the potential value of a collaboration between internal and external audit. The audit committee has the intention of combining these two sources of comfort through the development of complete synergy between internal and external audit in other words, an optimising the collaboration between them.

#### ***Internal Audit Provides Comfort***

The head of internal audit admits that she regularly receives specific requests from the audit committee. Through the members' questions on the coverage of the internal audit planning, specific audits reflecting major areas of discomfort are suggested. She illustrated this with several examples. Each audit committee request reflects a high-risk area for the company and, finally, becomes a priority during internal audit planning.

Similar to the head of the audit committee, internal audit focuses intensely on new risks that are emerging, as a result of cultural differences within the company worldwide; and on the resultant different levels of risk and control awareness that exist within the company. Therefore, given the strongly-formalised corporate culture, it is an important mission of internal audit to actively assist with the integration of newly-acquired companies, in order to make them evolve towards standardised, global company policies and procedures. This is an important aspect of their role as 'guard of the corporate culture'. More practically, by providing training and advice in local procedure development, internal audit tries to create comfort in this area. In order to meet these new challenges, the internal audit department also recently decided to engage two additional internal auditors: one based in the U.S. and one based in China.

General as well as specific internal control reviews, combined with suggestions for improvement, are the core tasks of internal auditing. When reviewing specific parts of the internal control system, internal audit applies a unique approach, based upon its own internally-developed control framework. By applying this approach, internal audit can develop unique knowledge regarding internal controls (cf. Abbott, 1988), which is a sound basis for providing a well-founded opinions on these internal controls. These opinions comprise an important source of comfort.

Besides the important assurance role illustrated above, internal audit clearly stresses its role supporting and assisting management. The internal audit website on the company intranet illustrates this vision:

“Did you ever think about calling in internal audit? In many situations, internal audit may be the partner you are looking for. We regard all audit projects as opportunities to assist you as partners in improving the effectiveness and efficiency of the business processes or activities you are responsible for [internal audit website on intranet].”

More specifically, internal audit has an important advisory role in developing and improving new controls, which can be considered as an important source of comfort. Moreover, having expertise as a member of working teams enables them to build valuable and unique knowledge, knowledge which they can use in their internal control reviews. In other words, the resulting abstract system of knowledge (cf. Abbott, 1988) makes them experts in providing comfort with respect to the internal control system (cf. Cooper, 1992; Reed, 1996).

In accordance with the expectations of the audit committee, the head of internal audit makes significant efforts to improve the relationship with the external auditor and, by doing so, actively contributes to an intensive collaboration. This is considered to be an important audit challenge for the future. More specifically, the head of internal audit regularly meets with the external auditor to exchange information on risks, problems and work performed, in order to avoid duplication. They even have the intention of developing a coverage chart, in an attempt to jointly achieve broader and better coverage of risk and internal control reviews, which will create even more comfort for the audit committee. Similar to Cases A and B, these efforts illustrate that the inter-professional competition suggested by Abbott (1988) and previously illustrated by Covalleski *et al.* (2003) is less apparent in the context of providing comfort to the audit committee on risk management and internal controls. Nevertheless, the head of

internal audit is convinced that the internal auditors have a unique perspective on the company and its operations (cf. Covalleski *et al.*, 2003), which enables them to provide even more comfort than the external auditors might:

“I always say to my auditors, your first working instrument is safety goggles, so that you can enter the plants... actually, that’s our favourite task. If you want to do an inventory audit and you’ve never been in the plant, then you don’t know what you’re talking about, and you can’t give an opinion on it [head of internal audit].”

### **EMPIRICAL RESULTS: CROSS-CASE ANALYSIS**

With respect to the overall status of their risk management and internal control systems, Cases A and D represent two extremes. In Case A, the company has a soft control environment and a very informal way of dealing with risk management and internal control. A well-developed risk management system and a clearly-defined risk management strategy are missing. In contrast, in Case D, the company aims to achieve a strong and uniform corporate culture with a high level of control awareness, guided by a company-wide and standardised Code of Conduct and Guide to Business Control. Accordingly, the company implemented an internally-developed and highly-formalised risk management system. Cases B and C appear to be situated somewhere between these two extreme cases. These companies, overall, have an informal way of approaching risk management and internal control, based upon a rather trust-based corporate culture and informal ‘common sense’. Nevertheless, there exists a sufficient level of risk and control awareness and essential formal internal controls to manage major risks. In other words, the formalisation of risk management and internal controls has started, and these companies now are in a ‘transition phase’. We found indications that this increasing interest in formalising risk management and internal control has resulted from the growing attention for it in corporate governance guidelines and best practices.

Based on a comparison between Case B and the other three cases, it becomes clear that the more the audit committee is aware of the importance of risk management and internal control for the company, as well as their own monitoring responsibilities, the more the audit committee deals with these topics during its meetings and, consequently, the more likely the members will encounter an information asymmetry problem (cf. Raghunandan *et al.*, 1998; 2001) creating feelings of uncertainty and discomfort. (cf. Pentland, 1993). Given their own growing monitoring responsibilities, feeling uncomfortable about risk management and

internal control strongly encourages the audit committee members to look for one or more sources of comfort. Moreover, we found indications that these feelings of discomfort are strengthened by the overall corporate approach and attitude towards risk management and internal control. Apart from Case B, wherein the audit committee perceives the internal auditor to be insufficiently independent from management, all audit committees view internal audit as playing an important purification role (cf. Pentland, 1993), and as a major source of comfort in the jurisdictional domain of risk management and internal control (cf. Abbott, 1988).

Except for Case B, all audit committees clearly expressed their needs for comfort with respect to the control environment, as the basis for risk management and internal control. Given the great distance between the audit committee and the operational level, thereby creating feelings of uncertainty and discomfort, the committee expects internal audit to play an important communicator role, so as to provide an overall impression of the risk and control culture, the integrity of people, and the different kinds of internal problems. Playing this translator role makes internal audit like a 'guard of the corporate culture'. In Case D, given the strongly formalised risk management system this company has, the need for comfort related to the control environment becomes more formalised, as internal audit is expected to monitor compliance with company standards of business conduct. Due to their internal position, their familiarity with and unique perspectives on the company, and their position close to the people on the floor, internal auditors seem to be the most suitable to provide comfort on the overall control environment (cf. Covaleski et al., 2003). In some cases, the audit committee even expects internal auditors to become facilitators for whistle blowing, thereby enabling people in the company to raise concerns about possible improprieties in financial reporting or other matters. Furthermore, having the right communication skills, as well as being able to listen to all kinds of people with an open and friendly attitude, is an attribute that seems crucial for playing this translator or facilitator role.

Besides the control environment, the case studies indicate that audit committees clearly need comfort related to internal controls in a limited number of company-specific high-risk areas. In order to signal their uncertainty and discomfort, audit committees (should) give clear input for the internal audit planning. With respect to these high-risk areas, audit committees expect internal audit to review the existence and effectiveness of existing internal controls, thereby providing them with a basic level of comfort, complete with recommendations. Furthermore,

audit committees feel more comfortable fulfilling their monitoring responsibilities with respect to internal control, when they see that internal audit is able to facilitate improvements in internal controls. The audit committee members derive comfort from the active involvement of internal audit in the improvement of internal controls. More specifically, this ranges from follow-up of their recommendations, to facilitating the implementation of recommendations, even to actively assisting management with the implementation of recommendations.

In those companies without a formalised risk management system, internal audit expresses their intentions to play a role in the formalisation process, by creating risk and control awareness and stimulating discussions on risk management and internal controls, which also can be considered to be a crucial source of comfort for the audit committee in this 'transitional phase'. Overall, being resolute and persuasive are important inter-personal skills for creating risk and control awareness and driving the formalisation process. Furthermore, internal audit often plays the role of educator to the audit committee, by providing them with background information, making the audit committee feel more comfortable with the theoretical underpinnings and importance of risk management, as well as its own monitoring responsibilities. Irrespective of the overall status of the risk management system, this educating role can be an important strategy by which internal audit can promote themselves as the expert in the jurisdictional domain of risk management and internal control (cf. Reed, 1996).

The case studies contained herein indicate that the basis for internal audit to provide comfort to the audit committee stems from a unique abstract knowledge base (cf. Abbott, 1988; Reed, 1996). This knowledge consists of general conceptual knowledge, as well as more specific company-related and practical knowledge on risk management and internal controls. It is important to see that the first component often results from prior work experience, often in external audit. This illustrates that the knowledge bases of internal audit and external audit not necessarily conflict, as suggested by Reed (1996) and Covaleski et al. (2003); rather, working together, internal and external auditors can create valuable synergies for the provision of comfort. The second component of knowledge comes from the internal auditors' familiarity with the many divisions of the company and their intimate knowledge regarding processes and procedures. Furthermore, Case D illustrates that internal audit's own unique approach towards reviewing internal controls, through the use of an internally-developed

control framework, enables them to develop idiosyncratic knowledge about internal controls, which is a sound and unique basis for providing comfort with respect to internal controls. Moreover, playing an active management supporting role in the improvement of internal controls often enables internal audit to build valuable knowledge that afterwards can be used in their internal control reviews.

These four case studies illustrate the point that internal audit reports and formal presentations at audit committee meetings - discussing major findings, recommendations, management reactions and action plans - are considered to be crucial output of the internal audit ritual (cf. Moore and Myerhoff, 1977; Pentland, 1993), transforming uncertainty and doubt about risk management and internal control into trust and stability (Cooper, 1992). Besides these formal symbols of comfort, informal contacts through face-to-face meetings with the head of internal audit or even attending internal audit team meetings seem to be important ways of providing comfort to the audit committee. Moreover, the internal audit charter, a regularly-used communication instrument that describes auditing roles and objectives, also is an essential instrument for internal audit to demonstrate the jurisdictional domains (cf. Abbott, 1988) in which they can provide comfort (cf. Reed, 1996).

We found indications that, despite their different knowledge bases and power strategies, the supposed inter-professional competition between internal and external audit suggested by Abbott (1988), Covaleski et al. (2003) and Rittenberg and Covaleski (2001), is less apparent in the context of providing comfort to the audit committee regarding risk management and internal controls. It becomes clear that combining the knowledge and expertise of internal and external audit via well-considered collaboration, offers an ideal way of combining both sources of comfort, and enhancing the overall level of comfort for the audit committee. It can be argued that the jurisdictional domain of risk management and internal control (cf. Abbott, 1988) is, to some extent, shared by the internal and external auditor, which makes a collaboration more attractive. In Case A, this collaboration specifically was launched to compensate for the limitations of having a single internal auditor. In Case B, the audit committee considers the external auditor to be the expert in reducing their major information asymmetry on internal controls, whereas the internal auditor provides the audit committee with more detailed investigations based upon input from the external auditor, as an additional expert aiming to reduce the remaining information asymmetry.

## CONCLUSIONS AND DISCUSSION

We can conclude that the notion of comfort (Pentland, 1993), as suggested by Gendron and Bédard (2006); Gendron et al., (2004) and Spira (1999) combined with concepts from the sociology of professions literature (Abbott, 1988; Cooper, 1992; Reed, 1996) provide a relevant theoretical framework to study the relationship between internal audit and the audit committee. This study contributes to the opening of the audit committee 'black box' (Spira, 2003; Turley and Zaman, 2004); and, given its limitations, also introduces some interesting areas for further research.

With respect to risk management and internal control systems, all four cases can be situated somewhere on a continuum ranging from 'not formalised' to 'strongly formalised'. Similar to what was found by Sarens and De Beelde (2006a), Belgian companies are moving towards a more formalised way of managing risks and developing internal controls, inspired by recent changes in corporate governance guidelines and best practices. This paper provided evidence that the status of the risk management and internal control system has a significant influence upon the specific needs for comfort among audit committees and, consequently, upon the specific ways in which internal audit can provide this comfort. In our opinion, this offers interesting opportunities for longitudinal research, to investigate how requirements for comfort change as the status of the risk management and internal control system changes over time.

We found that, the more the audit committee is aware of risk management and internal control issues and its own monitoring responsibilities, the more its members are dealing with them during their meetings and, consequently, the more they will be looking for sources of comfort, inspired by feelings of uncertainty and discomfort resulting from the information asymmetry problem suggested by Raghunandan et al. (1998; 2001). It became clear that, apart from one case, audit committees perceive internal audit to be an important source of comfort in the jurisdictional domain of risk management and internal control.

We found that audit committees require comfort in two specific areas. First, they often feel uncomfortable about the overall control environment of the company. Therefore, they expect internal audit to be the 'guard of the corporate culture', playing a communicator role between the operational and monitoring levels. Second, they need comfort with respect to internal

controls in a limited number of high-risk areas. In order to provide this comfort, internal audit must become actively involved in improving internal controls, which complements the basic level of comfort resulting from their regular review of internal controls. Knowing that management can call on internal audit to support and assist them, thereby actively contributing to the improvement of internal controls, seems to be a significant source of comfort for audit committees. This conclusion is in line with that of Gendron et al. (2004), who found that audit committee members become comfortable with internal controls by assessing the extent to which managers adopt appropriate measures to solve deficiencies highlighted in internal audit reports.

As suggested by Abbott (1988) and Reed (1996), a unique abstract knowledge base enables internal audit to develop a basic power strategy to provide comfort to the audit committee. This knowledge consists of general conceptual knowledge and more company-specific and practical knowledge on risk management and internal control. The former often results from previous work experiences in external audit; conversely, the latter comes from the internal audit's familiarity with the company, and intimate knowledge regarding its processes and procedures, which is in line with the findings of Covaleski et al. (2003). It should be clear that active involvement in improving internal controls allows internal audit to develop this important type of knowledge. Our study also confirms the importance of the inter-personal skills (e.g. communication skills) and attitudes of internal auditors when striving to be major providers of comfort to the audit committee.

Inspired by Power (1997), we found evidence that internal audit reports and presentations at audit committee meetings are important formal symbols that can generate a sense of increased comfort within audit committees. Additionally, informal or private contacts between internal audit and audit committees seem to be crucial to providing comfort, thereby confirming the growing importance of private meetings for audit committee effectiveness, as previously suggested by Gendron and Bédard (2006) and Gendron et al. (2004). We can argue that more thorough investigation of internal audit reports will provide additional, valuable insights into the notion of comfort in this context. Furthermore, observations of informal interactions between audit committees and internal audit would be the ultimate way to enhance our understanding of the complex relationship between them, as suggested also by Gendron and Bédard (2006) and Spira (2002).



Contrary to the concept of inter-professional competition suggested by Abbott (1988) and previously illustrated by Covaleski et al. (2003) and Rittenberg and Covaleski (2001), we found that combining the knowledge and expertise of internal and external audit via a collaboration is the ultimate way to combine both sources of comfort, and enhance the overall level of comfort for the audit committee. Using Abbott's (1988) terminology, we can conclude that the jurisdictional domain of risk management and internal control is, to some extent, shared by the internal and external audit profession. A more detailed study of this, let's call it 'combined comfort approach', including interviews with external auditors and an analysis of external audit reports, certainly would be an interesting contribution to the literature.

Besides internal and external audit, the case studies described in this paper indicate that CFOs, controllers and accounting professionals can be considered to be other relevant sources of comfort for the audit committee. Investigating the relative importance of all these providers of comfort more thoroughly will be an important challenge for future investigators.

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**Table 1: Overview of the Four Cases based on the Internal Audit Department**

	<b>Small IA Department</b>	<b>Large IA Department</b>
<b>Recently Started IA Department</b>	Case A	Less common
<b>Mature IA Department</b>	Case B Case C	Case D

**Table 2: Overview of the Four Cases based on the Audit Committee**

	<b>Case A</b>	<b>Case B</b>	<b>Case C</b>	<b>Case D</b>
<b>Number of AC members</b>	4	3	3	5
<b>Number of non-executive AC members</b>	4	3	3	3
<b>Number of independent AC members</b>	2	2	2	1
<b>Number of AC meetings in 2005</b>	3	4	6	3







**PAPER 5**  
**THE RELATIONSHIP BETWEEN INTERNAL AUDIT**  
**AND SENIOR MANAGEMENT**  
**A QUALITATIVE ANALYSIS OF EXPECTATIONS AND PERCEPTIONS**

Paper five studies the influence of another stakeholder of internal audit, namely senior management, on internal audit practices, which fits within the second research question of this dissertation (micro level). A thorough investigation of senior management and internal audit's expectations and perceptions towards each other, a relationship that has gained increased attention given contemporary corporate governance requirements, is an important contribution to the comprehensive picture this dissertation wants to draw.



**THE RELATIONSHIP BETWEEN INTERNAL AUDIT  
AND SENIOR MANAGEMENT:  
AN ANALYSIS OF EXPECTATIONS AND PERCEPTIONS<sup>15</sup>**

**Gerrit Sarens**

**Ignace De Beelde**

**Abstract:** This study, based upon Belgian case studies, provides a qualitative assessment of the relationship between internal audit and senior management, analysing the expectations and perceptions of both parties. We found that senior management's expectations have a significant influence on internal audit and that internal audit, generally, is able to meet most of these expectations. Senior management wants internal audit to compensate for the loss of control they experience resulting from increased organisational complexity. Senior management expects internal audit to fulfil a supporting role in the monitoring and improvement of risk management and internal control, and wants them to monitor the corporate culture. Furthermore, they expect internal audit to be a training ground for future managers. On the other hand, internal audit expects senior management to take the first steps in the formalisation of the risk management system. They are looking for senior management support, as this benefits their overall acceptance.

**Keywords:** internal audit, senior management, expectations, perceptions, case studies, Belgium.

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## INTRODUCTION

*“Internal auditors are rock stars now. This is their day in the sun...”*

(Bruce Nolop, an American CFO in Handy and Paterson, 2005, pp. 48)

Stakeholders of organisations increasingly are demanding that boards and executive management apply accepted governance principles, adhere to sound risk management, and demonstrate publicly that they are in control of their organisations. The Institute of Internal Auditors (IIA)' definition of internal auditing includes references both to assurance and consulting activities directed at the governance, risk management and internal control processes. Consequently, an internal audit activity that fulfils this definition is uniquely positioned to support the board and management as an essential component of their governance mechanisms (ECIIA, 2005). Moreover, Carcello et al. (2005) found indications that, thanks to this enhanced focus on corporate governance, effective oversight and sound internal controls, the importance assigned to internal auditing by management has increased. Furthermore, they suggest that senior management's expectations of the internal audit function have changed in profound ways.

Additionally, it has been found that an expectations gap arises when audit customers (for e.g. senior management) do not recognise the value of the internal audit (IA) function. In order to function effectively, internal auditors and the customers of audit services should possess a similar understanding of what makes internal auditing a value-adding activity. Failure to reach this understanding could result in the perception that internal audit simply is an obstacle to achieving organisational objectives. This can result in underutilised audit services and ignored audit recommendations (Flesher and Zanzig, 2000).

In academic research, most empirical work related to internal audit's relationship with other organisational parties deals with the relationship between internal audit and the audit committee (e.g. Goodwin, 2003; Goodwin and Yeo, 2001; Raghunandan et al., 1998; 2001; Spira, 1999). Even though, in practice, internal audit regularly interact with senior management (CEO and/or CFO) with respect to day-to-day activities, academic research on this relationship is very limited. Therefore, and given the importance of contemporary corporate governance requirements, this study, based on five Belgian case studies, aims to understand the relationship between internal audit and senior management (CEO and CFO).

More specifically, this paper provides a qualitative assessment of each side's expectations and perceptions with regard to the other.

For each case study, we conducted semi-structured interviews with the internal auditor or head of internal audit, the CEO and / or CFO. Moreover, we sought access to relevant, often confidential documents to support the insights we gleaned from these interviews.

This paper is structured as follows. The next section briefly describes the institutional context of this study. The third section reviews relevant literature and formulates the research questions. The fourth section outlines some methodological aspects. The fifth section presents the insights we gleaned from each individual case study and formulates cross-case insights. The last section summarises and discusses the conclusions of this study.

## **INSTITUTIONAL CONTEXT**

European companies face a challenging environment characterised by significant change, changes which include the globalisation of markets, the modernisation of communication technologies, and the enlargement of the European Union (EU), to name but a few. In such an environment, companies should benefit from a regulatory framework that encourages efficiency and competitiveness, while fostering sound and transparent corporate governance practices. It is with that aim in mind that the European Commission, in 2003, launched the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union. The plan currently is being implemented by the EU Commission through various legal initiatives aimed at improving governance and strengthening stakeholders' rights. In Belgium, there were three separate sets of rules drawn up by different authorities (1998), that needed to be updated and consolidated (Belgian Corporate Governance Committee, 2004).

At the initiative of the Banking, Finance and Insurance Commission (BFIC), Euronext Brussels and the Federation of Belgian Enterprises (FEB-VBO), a committee was established to draft a single code of best practice on corporate governance for all listed companies. The committee's aim was to draft a code aligned with international practice and EU recommendations. The comments received regarding its first draft, together with recent EU Commission initiatives, helped the committee to finalise the code, which was published on 9

December 2004 (the so-called Code Lippens). The code is based upon a ‘comply or explain’ system, which allows companies to deviate from the provisions of the code when their specificities so justify, subject to providing adequate explanation (Belgian Corporate Governance Committee, 2004).

On 21 September 2005, a corporate governance code for non-listed companies (the so-called Code Buysse) was launched, in order to meet the specific needs of this significant group of companies.

## **LITERATURE REVIEW AND RESEARCH QUESTIONS**

This section will provide necessary background information on the responsibilities of senior management in corporate governance, risk management and internal control, as well as on the two-way relationship between internal audit and senior management. This section also will provide insights from previously-published research on the relationship between internal audit and senior management.

### **Responsibilities of Senior Management in Corporate Governance, Risk Management and Internal Control**

Investigating national and international corporate governance guidelines and best practices, it becomes clear that good governance requires that the board of directors is responsible for applying high ethical standards; for guiding strategy and risk policy; for monitoring corporate performance; and for ensuring that appropriate systems of internal control are in place, including adequate identification and management of risks. The board often sets up an audit committee to assist in fulfilling its monitoring responsibilities, with respect to control in the broadest sense (Belgian Corporate Governance Committee, 2004; UK Combined Code, 2003).

It is the role of management to implement board policies on risk and internal control. In fulfilling its responsibilities, management should identify and evaluate the risks faced by the company for consideration by the board, and they should design, operate and monitor a suitable system of internal control which implements the policies adopted by the board (Belgian Corporate Governance Committee, 2004; UK Turnbull Guidance, 2005). Management should also strive to assure itself that the controls are working effectively, by

undertaking regular review activities (continuous monitoring) and receiving periodic reports (separate monitoring) from their own departments. This assurance activity is an essential part of a good control framework. Following recent scandals, and as part of measures to improve governance, management is required to demonstrate that it is fulfilling its responsibilities relative to the system of internal control. Therefore, not only does management need to have effective controls and to assure itself that these controls exist, they also must be able to demonstrate these facts to third parties: to the board, to statutory audit and even to the general public (ECIIA, 2005).

Note that all employees have some responsibility for internal control, as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces (UK Turnbull Guidance, 2005).

### **Internal audit as Support for Senior Management**

Senior management and the board may desire objective assurance and advice on risks and controls. An adequately-resourced internal audit function may provide such assurance and advice (UK Turnbull Guidance, 2005).

A professional internal audit activity will supplement senior management's actions, by providing independent and objective assurance on the effectiveness of the organisation's governance processes, how well it manages all kinds of risks, and whether internal control processes are operating, as required, to manage risks to an acceptable level. In other words, the CEO receives an independent and objective assurance on the quality of internal controls from someone other than the CFO or line managers, and/or the CFO receives independent and objective assurance on the quality of internal controls from someone other than the line managers and decentralised finance staff. Furthermore, internal audit can play a key role in monitoring a company's risk profile and identifying areas in which to improve risk management processes. Internal auditors also support management by providing consulting services, which contribute to the establishment of sound risk management processes, by facilitating management's efforts to improve the system of internal control, and by giving

advice on the implications of organisational changes to that system (ECIIA, 2005; Leithhead, 2000; Lindow and Race, 2002; Page and Spira, 2004; Spira and Page, 2003).

Even before the recent changes in corporate governance guidelines, a number of finance directors, surveyed in a study by Griffiths (1999), already recognised the major challenge for internal audit to lead the corporate governance agenda, which provides an opportunity for them to directly support senior management's requirements and responsibilities in this regard. A more recent study, by Page and Spira (2004), concludes that internal auditors generally view corporate governance guidelines - such as for example, the first UK Turnbull report (1999) - as beneficial to their cause, and reported that internal auditors claim that these guidelines have helped to alter perceptions of internal audit in a positive way, such that operating departments frequently sought the advice of internal audit when implementing new or changed processes. Furthermore, Goodwin-Stewart and Kent (2006) found evidence that companies with an integrated risk management framework are more likely to use internal audit. Additionally, their study confirms that internal audit is complementary to other risk management mechanisms, such as a designated risk manager.

Besides their significant assurance and consulting role in risk management, internal control and corporate governance, internal audit also can act as a support for management in terms of reviewing operational efficiency, investigating outcomes of financial initiatives, and providing knowledge of business activities (Cooper et al., 1996). Furthermore, internal audit sometimes is asked to work with senior management in various other (ad hoc) activities of the organisation, such as, for example, acquisitions, mergers, and systems development and implementation (Brody and Lowe, 2000). The rationale is that more can be accomplished through review, providing advice up front to management to assist it in setting business objectives (Bou-Raad, 2000).

### **Senior Management as Support for Internal Audit**

Besides the valuable supportive role that internal audit can play for senior management, a solid and constructive relationship with senior management also is critical for effective functioning of the internal audit activity (ECIIA, 2005). More specifically, Attribute Standard 1110 of the International Standards for the Professional Practice of Internal Auditing (2004) stipulates that "the chief audit executive should report to a level within the organization that allows the internal audit activity to accomplish its responsibilities". The related Practice



Advisory 1110-2 recommends that, besides having a functional reporting relationship with the audit committee, the Chief Audit Executive (CAE) must have an administrative reporting relationship with senior management (preferably, the CEO or another executive with sufficient authority) in order to achieve appropriate support to accomplish internal audit's day-to-day activities. In general, this support should include positioning the function and the CAE in the organisation's structure in such a manner that affords appropriate stature for the function within the organisation (e.g. unrestricted access to staff, information and documentation).

Additionally, certain Performance Standards (2010; 2020; 2060) address more specific means by which senior management can support internal audit. It is mentioned that the CAE should consider the input of senior management (CEO / CFO) during internal audit planning (see also Doyon, 1996; Hubbard, 2000). Thus, senior management can support internal audit by giving them specific input (requests), which often reflects high-risk areas or important business opportunities. The CAE, in turn, should inform senior management of the internal audit planning and resource requirements, including significant interim changes, both for review and approval. The CAE also should report periodically to senior management on the internal audit activity's purpose, authority, responsibility and performance relative to its plan (see also Leithhead, 2000). Furthermore, different levels of management, including senior management, should commit to providing prompt responses to recommendations from internal audit, to monitoring the implementation of action plans, and to keeping internal audit informed of plans, of changes to the risk and internal control profile of the organisation, and of major changes to the organisation's policies and procedures.

Figure 1 presents an overview of the two-way relationship that should exist between senior management and internal audit:

[INSERT FIGURE 1 HERE]

### **The Relationship between Senior Management and Internal Audit: Insights from Previous Studies**

Due to an often strong direct or indirect relationship between internal audit and the CEO and/or CFO, as suggested above, it is reasonable to expect that senior management is in a position to exert a significant influence over internal audit. Although Griffiths (1999) argues

that financial directors' expectations of internal audit are significant in relation to their role and development, the number of empirical studies that have investigated the relationship between senior management and internal audit is limited.

Although the audit committee should be responsible for the (re)appointment and dismissal of the CAE, McHugh and Raghunandan (1994) found that, especially in large companies, CFOs often have the authority to hire (31 percent of the companies) and fire (29 percent) the CAE. If the hiring/firing authority is vested with the audit committee, but senior management continues to have authority over the budget and evaluation of the internal audit department, internal audit remains highly 'dependent' upon the CEO and/or CFO.

An early Australian study, by Cooper et al. (1994), revealed a number of inconsistencies among CEOs and internal audit managers about the areas covered by internal audit. The areas which were most strongly supported by CEOs were not necessarily those in which internal audit managers indicated they spent a proportionate amount of their time. For example, there are clear differences in the perceptions of CEOs with respect to the audit of financial areas, compared with the reality reported by internal audit managers. The gap between CEOs' understanding of the extent of audit coverage and the time, in fact, being devoted to these areas truly only can be bridged by closer consultation within organisations (see also Mathews et al., 1995). Similarly, Galloway (1995) points out that managers may restrict the internal audit's role to that of evaluating internal controls over traditional areas such as accounting and finance.

Cooper et al. (1996) examined CEOs' perceptions with respect to internal audit in Australia, Malaysia and Hong Kong. The majority of the CEOs in their study perceived that internal audit had a consultative/participative approach. A large proportion of CEOs from all three countries believe in the traditional internal audit role of providing an independent appraisal of the internal control system. However, there was growing support for the more participative processes of an independent review of operational efficiency, and of management effectiveness.

Ridley and D'Silva (1997), comparing and contrasting senior managers' perceptions of internal audit value, also found that most senior managers saw internal audit in its traditional role of providing assurance through investigation, checks and assessment. Some recognised a

widening internal audit scope into new roles as consultants and advisers, particularly into controls associated with information technology and management performance. Remarkably, the pattern of management perceptions of the value derived from internal audit contributions was different between CEOs and CFOs. More CEOs than CFOs saw growth in the value of reports to regulators and reports on environmental issues. More CFOs than CEOs saw growth in the value of reports on internal control.

Contrary to what is recommended by the IIA, Griffiths' study (1999), which involved 92 FTSE 200 companies reveals that financial directors' perception of internal audit is by no means universally positive. The main concern was that the function was too low key and basic (and, therefore, insufficiently operationally- or business risk- oriented) or that the function was lacking in skills (or had a poor mix of skills and staff). In line with the views of financial directors in his study, internal audit needs to become much more business (risk) and operationally-oriented; it also needs to be more proactive, responsive and innovative, and to enhance the skills within the function, as well as the quality of its staff. In general, providing a more constructive contribution, via involvement in the assessment and management of business risk, would enhance financial directors' perception of the internal audit function. More specifically, managing the control and risk self-assessment process, or having significant involvement in its delivery, provides an opportunity for internal audit to directly support the financial directors' requirements and responsibilities in this regard.

A recent study by Van Peurseem (2005) found that internal audits are conducted in an environment of close and, sometimes, dependent associations with management, which makes their independence from management structurally at risk. She found that those who seem to be able to meet their own expectations also are those who most carefully balance the sometimes conflicting interests of their managers with the interests of their profession. Essentially, a key issue is that internal audit would assume whatever position is in the best interests of their employer and would be reluctant to counter management, irrespective of the consequences (Van Peurseem, 2004).

### **Research Questions**

This study attempts to formulate qualitative answers for the following research questions and, thereby, tries to extend the literature on the relationship between internal audit and senior management.

***Research Question 1:***

What does senior management expect the role of internal audit to be?

***Research Question 2:***

Does internal audit meet the expectations of senior management?

***Research Question 3:***

What does internal audit expect from senior management?

***Research Question 4:***

Does senior management meet the expectations of internal audit?

## **METHODOLOGY**

Complementary to the existing research in this area, which primarily is based upon quantitative data (e.g. Cooper et al., 1994; Cooper et al. 1996; Griffiths, 1999; McHugh and Raghunandan, 1994; Ridley and D'Silva, 1997) and similar to the recent study by Van Peurseem (2005), this study uses theory specification cases (Keating, 1995), in order to achieve more in-depth insights into the dynamic relationship between internal audit and senior management.

Contrary to large-sample studies that provide a generalisable set of findings related to a few pre-determined constructs, in-depth case studies produce much more detailed information, but about a limited number of people and cases (Patton, 2002). In this study, we focus on understandability, given the limited amount of in-depth knowledge on the relationship between internal audit and senior management. The inability to generalise from the data gathered in case studies to some larger population often is cited as a major weakness of case study research (Shaughnessy and Zechmeiser, 1985). Schofield (1990) argues that, instead of producing a standardised set of results that any other researcher in the same situation or studying the same issue would have produced, the goal of case study research is to produce a coherent and illuminating description of and perspective on a situation that is based on and consistent with detailed study of that situation.

The selection of the five companies (cases) for this study was partially theoretically driven and partially based upon experience with internal audit in Belgium. Previous research indicates a positive relationship between firm size and the establishment of the internal audit function (e.g. Chow, 1982); therefore, we controlled for firm size and selected companies

with at least 1,000 employees. Furthermore, all five companies operate on an international scale (Europe, US, Asia and Middle East). All companies, except Case A, were listed on Euronext Brussels at the time of the case study. Every company had an audit committee that consisted of a majority of non-executive directors and which met three to six times in 2005. Inspired by previous research on internal audit in Belgium (cf. Sarens and De Beelde, 2006a; 2006b), we also took into account the age of the internal audit function, as well as the number of internal auditors. Related to the first parameter, we included four companies with a mature internal audit function (having existed for more than five years) and one company that only recently had created an internal audit function (in 2004). Related to the second parameter, we selected four companies with a small internal audit department (less than five internal auditors) and one company with a larger internal audit department (five or more internal auditors). We refer to Appendix 2 of this dissertation for an overview of the five cases of this study.

For each case, we conducted a semi-structured interview (60 to 120 minutes) with the internal auditor (in Cases A, B and C) or the head of internal audit (in Case D and E) and with the CEO (in Cases A, B and E) or the CFO (in Cases C and D), depending upon the reporting relationship. Note that all interviews were conducted independent of each other, such that, for example, the answers of the CEO were not taken as input for the interview with the head of internal audit at that company. All interviews were tape-recorded and transcribed immediately after the interview had taken place. The interview instrument, containing guiding questions, was developed based upon the research questions, the literature review, and our experience with the internal audit profession in Belgium. In order to support the interview data and enhance the reliability of our conclusions, we obtained copies of a considerable amount of archival material such as the internal audit charter and the internal audit planning, and even more confidential documents like internal audit reports and internal presentations. Only one company (Case B) was reluctant to release these kinds of documents. Table 1 presents an overview of all collected data:

[INSERT TABLE 1 HERE]

Analysis of these qualitative data was based upon the analytical protocol recommended by Miles and Huberman (1994). More specifically, all interview transcripts and documents were coded. Next, the most important observations were summarised for each company (within-

case analysis) and sent back to the interviewees to obtain their confirmation. They were asked to react openly and add new comments, if necessary. These adjusted insights were translated into standardised matrices that facilitated the discovery of patterns through cross-case analysis.

## **EMPIRICAL RESULTS**

In this section, we will outline the major insights from each case study (within-case analysis), followed by an overview of the cross-case analysis.

### **Case A**

The expectations and perceptions in this case are strongly influenced by the fact that the internal audit function had been in existence only one year. The internal auditor reports administratively to the CEO. The CEO is aware that the internal audit function still is not fully accepted by everyone in the company. He is convinced that it is not easy to install such a function, as this requires a change of mentality which will take a few years:

“Starting such a function is not easy. (...) We will have to work to change the mentality. I think this will take three to four years... it is a long-term investment [CEO]”

Therefore, he expects the internal auditor to spend enough time and effort on the promotion and marketing of his function. Furthermore, he finds it very important that the internal auditor becomes acquainted with the company, in order to become fully accepted, especially by senior management.

Besides these general expectations, the CEO also has more specific expectations with regards to the internal auditor. First, the CEO expects the internal auditor to compensate for the loss of control that arises from the recent growth of the company through foreign acquisitions. This was clearly the major driver to install the internal audit function:

“We are a growing company. Our growth almost exclusively is based on foreign acquisitions, which leads to a potential loss of control, as well as to cultural problems. (...) The internal auditor should be located between the corporate level and the local network. They then should conduct audits in our local network and report their findings to us [CEO]”

Second, the CEO wants the internal auditor to become a supporting function in those activities that receive high management priority (e.g. future acquisitions). Therefore, together with the executive committee, he attempts to strongly influence the internal audit agenda. The internal auditor is aware that he will have to adapt his agenda to the expectations of the CEO, in order to become accepted. To some extent, the internal auditor is prepared to play the expected management supporting role in order to get this support and, therefore, to receive input pertaining to his audit planning from the CEO and other senior managers. However, he does not want to service a purely consulting function for senior management, as he wants to maintain sufficient autonomy to determine his agenda. As soon as senior management has accepted his function, the internal auditor expects productive discussions with them on his findings, conclusions and recommendations, which should improve their relationship. To date, these discussions have not taken place.

Third, the CEO wants the internal auditor to approach risk management from a broader, company-wide perspective, complementary to local managers who have a more-focused view on the specific risks of their division. More specifically, the internal auditor is expected to complete a company-wide risk map. Furthermore, the CEO expects the internal auditor to create, through his work, a reasonable level of risk awareness within the company. However, given the corporate culture that stimulates risk-taking, the CEO wants the internal auditor to avoid creating too much risk awareness, which would temper the company's growth. In other words, he expects the internal auditor to work "in line with the existing corporate culture."

The internal auditor is convinced that he has to play a pioneering role in the introduction of a more formal way of risk management within the company. Nevertheless, he perceives senior management as not giving the right signals to operational management, as they stimulate uncontrolled and extreme risk-taking behaviour. Besides, senior management has a rather averse attitude towards internal controls. Therefore, he expects senior management to change their attitude towards risk management and internal control. More specifically, senior management must start thinking about a clear and specific risk and control strategy:

"A consistent strategy with regards to control and the internal control system should be designed by management [internal audit presentation]"

"That is a fundamental objective that I have to meet: getting management to start thinking about a control strategy [internal auditor]"

Furthermore, senior management is expected to formulate clear policies and procedures, in order to indicate what is acceptable to achieve objectives:

“There are no policies that define the perimeter within which the strategic objectives must be reached [internal audit presentation]”

He is convinced that this is necessary to create a supportive environment for internal audit:

“I can not work in an organisation that does not say what is acceptable and what is not, while striving to meet objectives [internal auditor]”

Although the CFO and the Chief Operations Officer are aware of the importance of formalising risk management and internal controls, the internal auditor knows that convincing the CEO will be a fundamental step. He wants to make it clear to him that he will support senior management in this process.

### **Case B**

In this company, the internal audit function has existed for more than 15 years, but always has been performed by a single internal auditor. The most recent internal auditor had been appointed six months before the case study took place. The internal auditor reports administratively to the CEO. According to the CEO, internal auditors always have been accepted within the company, thanks to their practice-oriented way of working, close to the people in the field. The CEO perceives his relationship with the internal auditor as strong. Furthermore, the CEO and CFO both attach great importance to promoting the internal audit function within the company:

“When this internal auditor was engaged, we sent a note to everyone in the company to make sure that they all know the role of internal audit and what is expected from them as a reaction to his work [CEO]”

Thanks to the open communication about his function, the internal auditor is convinced that everyone in the company perceives his role in the same way.

Data analysis reveals three specific expectations of the CEO regarding the current internal auditor. First, he expects the internal auditor to perform independent evaluations of systems and procedures, in order to provide him with a sufficient level of assurance. The internal auditor confirms that an important part of the added value of his work results from his provision of assurance regarding internal controls to senior management and the audit committee.



Second, the internal auditor is expected to be a continuous improvement tool, focused on improving the effectiveness and efficiency of processes and procedures. The internal auditor stresses that, besides his assurance role, he clearly operates as a management assistant in improving processes and procedures. This is confirmed by the recently-updated internal audit charter:

“The overall objective of the program of internal audit is (i) to assist all levels of management in the effective discharge of their responsibilities by providing independent analysis, appraisals, advice and recommendations concerning the activities reviewed; and (ii) to assist management in obtaining the company’s goals and objectives. Internal auditing is an advisory function having independent status within the company [internal audit charter]”

The CEO confirms that the internal auditor meets these two expectations. Thanks to his work, the efficiency of some specific processes clearly has improved. Therefore, the CEO wants internal audit to focus even more on continuous improvement through the engagement of an additional internal auditor:

“It is because we saw all these improvements, that we are thinking about hiring an additional junior auditor. (...) We reviewed the internal audit tasks and decided that we want to extend this more toward continuous improvement [CEO]”

Third, the CEO expects the internal auditor to play a role in the formalisation of the risk management system; for example, by coordinating the development of a centralised risk database. Inspired by his working experience in external audit, the internal auditor agrees that he wants to become actively engaged in the evolution towards more formalisation:

“I am used to working in a very formal environment, where everything is well-documented [internal auditor]”

More specifically, he will indicate the weaknesses in the current risk management approach, provide recommendations based upon his experience within other companies and even assist management by providing them with tools to implement these recommendations.

While constructing his audit planning, the internal auditor expects the CEO and CFO to indicate high-risk areas on which to focus his work, as he still lacks sufficient knowledge about the company. The CEO agrees that he, as well as the CFO, have a strong influence on the internal audit planning by suggesting specific topics to include and asking the internal auditor to reserve sufficient time for ad hoc requests during the year. Before every audit, the CEO and CFO also can suggest specific issues they want to have included in that specific

audit. Furthermore, the CEO and CFO both are actively interested in the internal audit reports and the follow-up of recommendations. They have monthly meetings with the internal auditor to discuss the internal audit work and the reactions of operational management to it. If necessary, they intervene to has the implementation of his recommendations which the internal auditor feels is important.

### **Case C**

In this company, the internal audit function has existed for 16 years and has, similar to Case B, always been performed by one internal auditor. The current internal auditor has performed this function for two years and reports administratively to the CFO. Although the CFO notices that the current internal auditor generally is accepted and positively perceived within the company, thanks to his constructive way of working, he has to admit that the current internal auditor still has limited maturity and experience in the business. The CFO does not rule out that this can have an impact on the perception of his work. The internal auditor agrees that, contrary to how it is with senior management, among those at the lower levels of the company, he is still perceived as a police officer focused on finding problems and mistakes:

“Last week, I was at our Australian subsidiary and their first reaction was: there is the ABC [name of the company] police [internal auditor]”

Fortunately, this is in most cases, only the initial reaction, which is precipitated by ignorance about the role of internal audit. As soon as people know what the internal auditor is doing and what they can expect from him, their perception changes. The expertise of the current internal auditor is limited to financial, accounting and organisational areas, which has an impact on the scope of the audit planning. The internal auditor would prefer to hire an additional internal auditor, but he is not sure whether senior management would be keen on this.

The major expectation of the CFO vis-à-vis the internal auditor can be summarised as a detailed and focused control of processes and procedures to investigate whether they are adequate and correctly followed. He expects the internal auditor to provide him with feedback on this (assurance), as well as with sufficient recommendations to improve the processes and procedures. The core task of internal audit, as described by the internal auditor, corresponds more or less with this expectation. He describes his work as focused on

evaluating the internal controls, especially because they have an important influence on financial reporting, in order to provide assurance on these controls and recommendations to improve them. Thus, his most primary focus is on the internal controls. Improving the processes, from a broader point of view, is rather a secondary objective.

More specifically, the CFO expects the internal auditor to base his work on personal contacts with people in the field:

“I expect the internal auditor to base his work on personal contacts with the people who are audited... we do not have a culture to arrange such things by mail or email... he has to do his work on site [CFO]”

The internal auditor agrees that the most important aspect of an audit is listening to the people, giving them the opportunity to raise issues, and provide their opinions. Furthermore, the internal auditor perceives himself as a facilitator for whistle-blowing, especially for financial people. However, the CFO is not convinced of this role, given the internal auditor’s limited maturity and experience with the company.

The CFO perceives his relationship with the internal auditor as constructive. Together with the CEO, he is involved with the development of the internal audit planning. Their input primarily is based on the monthly business review meetings they have with lower management, combined with their own risk assessments. The internal auditor confirms that every internal audit planning is discussed with the CEO and CFO, in order to ensure that all proposed audits are relevant in their eyes. Furthermore, the internal auditor is satisfied that the CEO and CFO pay sufficient attention to his recommendations and their follow-up. The CFO confirmed that they pay attention to the results of the internal audit work during their business review meetings. He agrees that the internal audit reports meet his expectations and that they create a certain level of risk and control awareness within the company. Besides, the CFO is convinced that the work of the internal auditor adds value to the company, although only on a limited scale:

“There are value adding aspects in his audit reports, but no world-shaking things... but he adds value. They are perceived like that by most people in the company [CFO]”

Although the CFO does not express any expectations about the role of the internal auditor in risk management, the internal auditor expects senior management to start formalising their

way of risk management in a more professional way, as well as documenting the internal control system:

“Policies and procedures... most of them are rather common sense and informal, which does not mean that they are not working well, but there is still room for improvement. It is mainly because top management still prefers to arrange things rather informally [internal auditor]”

Nonetheless, he is convinced that the company is not yet ready for this. Remarkably, he does not see an important role for himself in this formalisation process, which probably can be explained by his limited capacities (resources and expertise).

#### **Case D**

In this company, the internal audit department has existed for more than 20 years and recently increased from seven to ten internal auditors. The internal audit manager reports administratively to the CFO. Both the CFO and the internal audit manager agree that internal audit is appreciated and positively perceived within the company. This has increased significantly over the last three years, thanks to the support internal audit receives from senior management, which has increased the level of awareness regarding their work. Besides his significant influence on the internal audit agenda through involvement in annual risk assessments and specific ad hoc requests during the year (note that these represent 25 percent of the annual audit planning), the CFO openly reacts to audit reports and supports the internal audit findings and recommendations. He clearly shows to everyone that he perceives internal audit as an important function. Senior management also supported the recent appointment of three additional internal auditors. Furthermore, internal audit has improved the communication of their added value to the company significantly, especially through their risk assessments, audit reports and meetings, all of which has enhanced the acceptance of their function:

“By performing risk analyses, we show them the risks they are exposed to... this really helped us to receive recognition, especially within the older business units [internal audit manager]”

Additionally, the CFO and internal audit manager confirm that the corporate scandals of the last decade and the resulting legislative initiatives (especially the US Sarbanes-Oxley Act) have had a positive impact on the level of attention to controls in general and to internal audit more specifically. Furthermore, they agree that two recent small fraud cases within the company positively contributed to the acceptance of internal audit:

“I am not happy that this happens, but it is good to have such cases, that shake people awake and prove the benefit of having an internal audit function. (...) You could argue that they could have given signs that this was going to happen [CFO]”

Overall, the CFO expects the internal audit department to be an adequate training ground for future potential managers, where they can work for two or three years and collect relevant expertise and knowledge about the company. To date, he is satisfied with the rotation of the internal auditors. Conversely, the internal audit manager is less happy with the high degree of rotation:

“Currently, I do not have enough people with audit experience and company experience. This is becoming a problem. (...) Internal audit is a kind of fishing pond full of high potential, but they can’t empty it completely [internal audit manager]”

We were able to distinguish additional specific expectations of the CFO with regards to internal audit. He expects internal audit to be a supportive function for management, instead of a pure control function. More specifically, he expects internal audit to support management in risk identification, risk assessment and risk management, as well as in monitoring and improving risk management and internal controls. It seems that the current internal audit program, which focuses on overall internal control reviews, meets the expectations of the CFO. It is interesting to note that the internal audit department has developed its own approach to evaluating the internal control system, which enables internal audit to perform a more thorough evaluation and provide a higher level of assurance. Moreover, the internal audit manager stresses that it is more important for them to assist management via improvements in internal controls than by formulating mere opinions about them. Internal audit also reserves a certain amount of their work time to become engaged as advisors in consulting projects. By playing this supportive role, they are able to meet this important expectation of senior management. This is clearly communicated through the company intranet:

“Internal Audit’s services are available to all divisions and may provide useful support in a wide variety of business processes [company intranet]”

With respect to internal controls, the CFO expects internal audit to play an active role in the implementation of a uniform internal control system within the whole company, thereby taking into account the cultural and human differences between the various subsidiaries. The internal audit manager agrees that the department regularly provides training and advice in local procedure development and, thereby, monitors and contributes actively to the

application of standardised policies and procedures. Furthermore, the CFO expects internal audit to create the necessary level of control awareness. The internal audit manager is convinced that internal audit's work contributes to a higher level of control awareness, especially among non-financial managers. In this context, internal audit also wrote the Company Guide to Business Control that concisely summarises all policies and procedures at a group level; the guide was distributed to all management levels.

### **Case E**

In this company, internal audit has existed as an independent function for 13 years and currently is staffed with three internal auditors. The Chief Internal Auditor reports administratively to the CEO. Overall, the CEO is convinced that internal audit currently is perceived within the company as supportive and value adding. According to the Chief Internal Auditor, his department has been more valued over the last three years thanks to its more systematic and professional approach. More specifically, internal audit started to develop their cycle-based audit planning in a more formalised way with the intention of providing an "in control statement" combined with a more systematic way of reporting and following-up on the implementation of their recommendations. The Chief Internal Auditor also admits that, thanks to the new senior management team and especially the new CEO, the level of attention paid to internal audit in general and their audit reports more specifically has increased significantly, which led to some important improvements within the company:

"I have received some positive echoes from local managers: thanks to the recommendations of internal audit, a process of change has been started... that is nice to hear [Chief Internal Auditor]"

The CEO agrees that he is satisfied with internal audit. He sometimes provides input for the audit planning and is actively following up on the recommendations of internal audit, by putting them on the agenda of his business meetings with local divisions, an important way "to make things happen":

"If necessary, I pick up the phone and ask the local manager why he did not react to the recommendations [CEO]"

Again, this illustrates the crucial importance of senior management support for the acceptance and impact of internal audit within a company.

Similar to the CFO in Case D, the CEO expects the internal audit department to be a training ground for future managers who can be of great value in other functions. Contrary to Case D, the Chief Internal Auditor considers this to be a valuable attribute of his department. Recently, one of his internal auditors moved to another department, and the Chief Internal Auditor is convinced that he will take the internal audit philosophy with him and will actively contribute to improving the processes and internal controls within his new department.

Data analysis reveals four more specific expectations of the CEO, vis-à-vis internal audit. First, and similar to Case A, the CEO clearly expects internal audit to compensate, through their work, for the loss of control that has resulted from the rapid growth of the company through many international acquisitions:

“I have no problem with decentralisation, but this also means that you have the right to control them. You can control through reports, but also through those things that are not emerging in the reports and that is where internal audit comes in. (...) Internal audit has to make sure that I sleep soundly [CEO]”

The Chief Internal Auditor confirms that, given the growth that has occurred through acquisitions, the creation of a uniform reference framework of policies always has been an important priority for his department.

Second, the CEO expects the internal audit department, staffed with people who know the business, to focus their monitoring work on processes and procedures. The Chief Internal Auditor agrees that the internal auditor’s major objective is to provide assurance to management via performance of operational audits. More specifically, they want to make sure that processes and related internal controls are effective and efficient and that relevant and important risks are identified and managed. Moreover, they always look at the effect of the processes under review on financial reporting.

Third, the CEO wants internal audit to safeguard the corporate culture, especially because of their regular personal contacts with people in the field:

“They hang around in the divisions of the company and sometimes they have particular feelings about certain topics... although they do not have hard data to support these suppositions, these feelings often are of great interest to me [CEO]”

This is a major driver for the CEO to have regular informal contacts with the Chief Internal Auditor.

Fourth and given the importance of acquisitions for the growth of the company, the CEO expects the internal audit department to play a value-adding role in due diligence work. He perceives their judgment and advice as invaluable, particularly because they know the business very well. Therefore, internal audit always has a member on any ad hoc composed acquisition teams. The Chief Internal Auditor confirms that the internal auditors spend, on average, 15 percent of their annual work time on due diligence work. More generally, the CEO expects that internal audit's advisory role in strategically-important projects will become more prominent in the future. Similarly, the Chief Internal Auditor has clear intentions of focussing more on assisting and supporting management, by playing a proactive consultative role, which will make management more capable of anticipating potential problems.

Similar to Cases A and C, the Chief Internal Auditor expects senior management to pay more attention to the integration and formalisation of the risk management policy, as this currently is rather fragmented throughout the company. Internal audit regularly signals this shortcoming, which recently led to increased awareness, as several departments put particular aspects of risk management into practice. Because the Chief Internal Auditor is convinced that the risk management policy still is far from well-structured at the corporate level, he is prepared to assist management in this process, without assuming any responsibility for it.

### **Cross-Case Analysis**

In three of the five cases, internal audit reports administratively to the CEO; in the two remaining cases, to the CFO. Cross-case analysis reveals four general expectations of senior management vis-à-vis internal audit. First, senior management expects internal audit to compensate for the loss of control that results from the increased corporate complexity that, in turn, is the result of growth through mergers and acquisitions internationally, as well as the continuous trend towards decentralisation. Second and contrary to Galloway's findings (1995), they expect internal audit to serve a supporting function, instead of a pure control function. The meaning of this role depends upon the specific case and will be summarised below. Third, senior management sometimes wants internal audit to be a training ground for future high potentials. It is understandable that internal audit departments consisting of several internal auditors are better able to cope with a high rotation rate and, consequently, to meet this expectation. Note that internal audit's perception of its role as a training ground is not uniformly positive. Fourth, senior management expects internal audit to be the safeguard of the corporate culture and, consequently, attach great importance to the personal contacts



the internal auditors have during their work with people in the company. Therefore, they expect internal auditors to have appropriate communications skills. Sometimes, they even expect internal audit to be facilitator for whistle-blowing.

When looking into the specific meaning of the supporting role senior management expects internal audit to play, we could distinguish several areas. First, and similar to what was reported in Cooper et al. (1996), senior managers expect internal audit to evaluate, in an independent way, the effectiveness and efficiency of processes in general, and of internal controls more specifically, in order to provide them with a sufficient level of assurance, which supports them in fulfilling their growing monitoring responsibilities. Internal audit confirms that they still focus on the provision of assurance, primarily with respect to internal controls, to their different 'clients', which include senior management.

Second and in addition to the provision of assurance, senior management expects internal audit to actively contribute to improving the effectiveness and efficiency of the internal controls and processes. Internal audit agrees that they spend a significant proportion of their time and effort supporting management by providing recommendations, assisting management with the implementation of these recommendations, and performing of ad hoc consultative work in strategically-important projects (e.g. acquisitions), often as the result of specific management demand (cf. Brody and Lowe, 2000; Ridley and D'Silva, 1997). Furthermore, they actively contribute to the development and implementation of a uniform and standardised internal control system throughout the several subsidiaries of the company, thereby attempting to compensate for the loss of control experienced by senior management. Internal audit is convinced that this role adds value to their company.

Third and depending on the status of the risk management system, senior management often expects internal audit to assist with the formalisation of the risk management system. Moreover, senior management expects internal audit's work to create a sufficient level of risk and control awareness within the company, taking into account the overall corporate culture and attitudes towards risk and control. Besides their own role in risk management, internal audit expects senior management, which has the final operational responsibility for risk management, to take the first steps in this formalisation process, by changing their own (often averse) attitudes towards risk management and internal control and by giving the right signals and stimuli to the lower management levels. As also suggested by Goodwin-Stewart and

Kent (2006), internal audit appears to be convinced that a formalised risk management and internal control system is a more supportive environment in which they can work. Internal audit is, in most cases, convinced of their own (pioneering) role in formalising risk management (see also Sarens and De Beelde, 2006a). This role differs from case to case, and ranges from creating awareness to becoming actively involved in the formalisation process.

The cross-case analysis clearly indicates that the acceptance and appreciation of the internal audit function within the company is strongly dependent upon the support of senior management. In other words, the extent to which senior management supports the internal audit function, has a strong signalling function within the company. More specifically, this support is translated into the input senior management provides for the annual internal audit planning, the number of ad hoc requests senior managers have during the year, the attention they pay to the outcomes of internal audit work, the way they follow-up on internal audit's recommendations and resulting action plans and their support for an expansion of the internal audit function through the engagement of additional internal auditors. It should be clear that these are indicators of the strength of the relationship between internal audit and senior management. Consequently, internal audit, who actively is looking for senior management support, expects to receive input from the CEO and CFO on a regular basis, as well as to have productive discussions with senior management on the results and follow-up of their work. Furthermore and complementary to senior management's support, internal audit's own efforts to promote their function through, for example more explicit communication regarding their added value, also augment the acceptance of their function. Similar to Carcello et al. (2005), we found indications that the recent corporate scandals and resulting increased attention for corporate governance, have contributed to an increase in the overall level of appreciation for internal audit. Even some small fraud cases at company level can enhance the level of attention paid to internal audit's work. The cross-case analysis also suggests that the acceptance and appreciation of internal audit by senior management is influenced by the maturity of the internal audit function. In Case A, the young internal audit function was confronted by some ignorance about the role of internal audit, which necessitates the promotion of the function through clear and intensive communication (cf. also Cooper et al., 1994).

Similar to Griffiths' findings (1999), it becomes clear that senior management's expectations have a significant influence on internal audit. Contrary to Cooper et al. (1994), the cross-case

analysis did not reveal significant inconsistencies between senior management's expectations and the actual internal audit work. Furthermore and contrary to Griffiths (1999), most CEOs and CFOs are satisfied with the work of internal audit in their company. In other words, internal audit more or less is able to meet the expectations of senior management and, in most cases, they receive the expected support from senior management in return.

## **CONCLUSIONS AND DISCUSSION**

This study focused on the relationship between internal audit and senior management, by investigating qualitatively their expectations and perceptions with respect to each other. Based on extended data analysis, we can conclude that senior management's expectations have a significant influence on internal audit. Overall, internal audit is able to meet most of these expectations, which makes senior management support them.

When investigating the expectations of CEOs and CFOs in this study, it became clear that they expect internal audit to compensate for their loss of control resulting from increased organisational complexity. Given that, in three of the five cases, the internal audit function is performed by a single internal auditor, it probably is not easy for them to meet this lofty expectation. Expansion of the internal audit function or collaboration with other individuals (e.g. controllers) would not seem to be a superfluous luxury. Given internal audit's contacts with people in the field, senior management also wants internal audit to be the safeguard of the corporate culture.

Overall, senior management expects internal audit to serve a supportive function by (1) providing independent assurance on the effectiveness and efficiency of processes and internal controls; (2) actively contributing to the improvement of processes and internal controls; and (3) assisting with the formalisation of the risk management system. In most cases, internal audit is able to meet these expectations by focussing on the provision of assurance combined with sufficient recommendations and the performance of ad hoc consultative work. Furthermore, they actively contribute to the development and implementation of a uniform and standardised internal control system and the creation of a sufficient level of risk and control awareness throughout the company. With respect to the formalisation of the risk management system, internal audit expects senior management to take the first steps in this process, by changing their own attitudes and giving the right signals and stimuli to lower

management levels. A formalised risk management and internal control system is considered to be a more supportive environment for internal audit. Because many companies only recently initiated this formalisation process, an interesting research opportunity exists to monitor the changing role of internal audit through this formalisation process.

Moreover, it became clear that larger internal audit departments, those staffed with more than one internal auditor, are expected to be training grounds for future managers. Contrary to senior management, internal audit managers do not always like this idea, given the resulting high rate of rotation within their staff. Further research can go deeper into the motivations behind recruiting former internal auditors as managers and possible ways for management to convince an internal audit department to become a 'school' for management prospects.

We conclude that the acceptance and appreciation of internal audit within the company is strongly depending on the support they get from senior management reflected by their input for the internal audit planning, their ad hoc requests during the year, their follow-up on the outcomes of the internal audit work and their support for an extension of the internal audit function. It became clear that internal audit is actively looking for this management support and combines it with their own efforts to promote the function, taking into account the maturity of the internal audit function within the company. Furthermore, the enhanced attention for corporate governance and sometimes fraud cases within the company have also contributed to an increase of the appreciation for internal audit.

In Belgium, internal auditing is a relatively young profession. Therefore, it would be interesting to conduct the same in-depth study within other countries, wherein the internal audit profession is more mature, and see whether such case studies lead to the same conclusions. Given that case studies do not lead to generalisable results, a large-scale study, using, for example a questionnaire, might be used to validate the insights of this study. This study focused on the interactions between internal audit and people highly-positioned in the organisational hierarchy. Investigating how people at other organisational levels (e.g. middle and operational management) look upon internal audit definitely would complement this study. Probably, difficulties related to the ignorance of the internal audit function would be more predominant at lower operational levels.

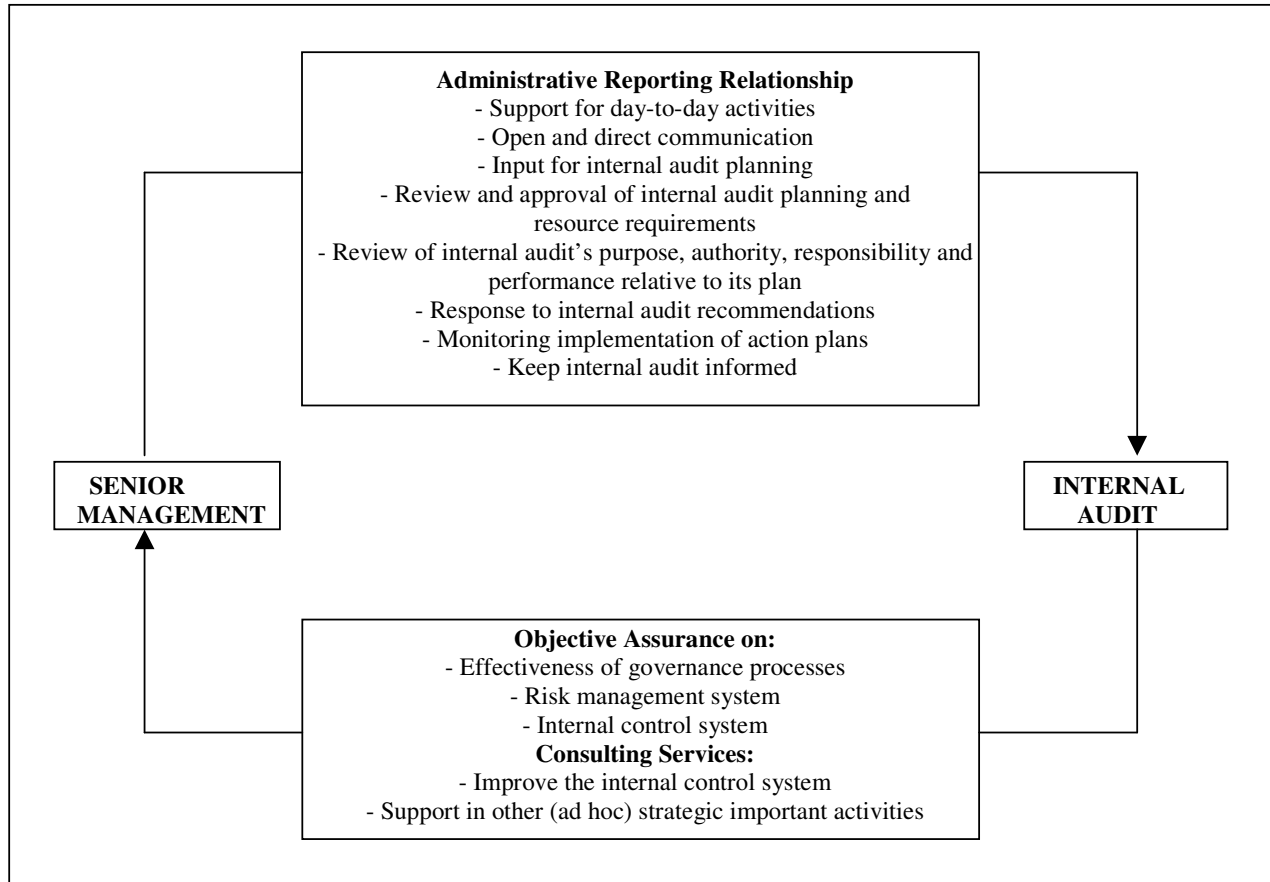
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**Figure 1: Relationship between Internal Audit and Senior Management**





**Table 1: Overview of the Qualitative Data**

	<b>Case A</b>	<b>Case B</b>	<b>Case C</b>	<b>Case D</b>	<b>Case E</b>
<b>Interview</b>	<ul style="list-style-type: none"> <li>• CEO</li> <li>• Internal Auditor</li> </ul>	<ul style="list-style-type: none"> <li>• CEO</li> <li>• Internal Auditor</li> </ul>	<ul style="list-style-type: none"> <li>• CFO</li> <li>• Internal Auditor</li> </ul>	<ul style="list-style-type: none"> <li>• CFO</li> <li>• Internal Audit Manager</li> </ul>	<ul style="list-style-type: none"> <li>• CEO</li> <li>• Chief Internal Auditor</li> </ul>
<b>Documents</b>	<ul style="list-style-type: none"> <li>• Internal audit charter</li> <li>• Internal audit planning</li> <li>• Internal audit report</li> <li>• Internal audit presentation</li> <li>• Control matrices</li> </ul>	<ul style="list-style-type: none"> <li>• Internal audit charter</li> </ul>	<ul style="list-style-type: none"> <li>• Corporate Governance Charter</li> <li>• Management letter external auditor</li> <li>• Internal audit reports</li> <li>• Internal audit planning</li> <li>• Follow-up document</li> </ul>	<ul style="list-style-type: none"> <li>• Code of Ethics</li> <li>• Business Control Guide</li> <li>• Internal audit planning</li> <li>• Internal audit presentation</li> <li>• Intranet pages on internal audit</li> </ul>	<ul style="list-style-type: none"> <li>• Internal audit charter</li> <li>• Presentation audit methodology</li> <li>• Internal audit planning</li> <li>• Overview audits conducted</li> <li>• Internal audit report</li> <li>• Internal audit presentation</li> </ul>







**PAPER 6**  
**A RESEARCH NOTE ON**  
**THE RELATIONSHIP BETWEEN THE CONTROL ENVIRONMENT**  
**AND THE SIZE OF THE INTERNAL AUDIT FUNCTION**

The sixth paper combines the insights from the previous four qualitative papers to develop alternative explanations for the size of the internal audit function, and therefore refers to the first research question of this dissertation (macro level). Instead of being conclusive, this paper is focused on the development and operationalisation of new explanatory variables that complement the existing agency variables tested in paper one. The major aim of this paper is to validate conclusions coming out of the case studies and to draw a conceptual model for further research on the size of the internal audit function.



**A RESEARCH NOTE ON  
THE RELATIONSHIP BETWEEN THE CONTROL ENVIRONMENT AND  
THE SIZE OF THE INTERNAL AUDIT FUNCTION<sup>16</sup>**

**Gerrit Sarens**

**Abstract:** This study attempts to contribute to the literature by developing three control environment variables, reflecting the contemporary context in which internal auditing is operating, and testing how these variables are related to the size of the internal audit function. Data were collected through a questionnaire sent to Chief Audit Executives. The new control environment variables turned out to be relevant when studying the size of the internal audit function. The results show that the degree of formalisation of the risk management system and the risk culture are both positively associated with the size of the internal audit function. Furthermore, the significance of the control environment variables seems to be different between the smallest and largest companies in this study. The results of this study lead to a conceptual model for further research.

**Keywords:** internal auditing, control environment, Belgium

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## INTRODUCTION

Increased demands for accountability have made organisations' risk management and internal control systems part of public policy debates on corporate governance. Many national and international corporate governance regulations and guidelines, including recent initiatives taken by the European Commission (2003), clearly demand that boards of directors and executive management adopt sound risk management and internal control. By stating that internal auditing should evaluate and contribute to the improvement of risk management, control and governance, the Institute of Internal Auditors (IIA, 2004) formally recognises the assurance and consulting role of internal auditing in corporate governance.

Recent studies in different countries have illustrated the growing importance of internal auditing as a crucial player in corporate governance (Carcello et al., 2005a; 2005b; Goodwin-Stewart and Kent, 2006; Paape et al., 2003; Spira and Page, 2003). Nevertheless, establishing an internal audit function is only formally required for companies listed on the New York Stock Exchange (SEC, 2003) and for companies operating in the banking and insurance industry (Basel Committee, 2001). Although all other companies are stimulated by corporate governance best practices to consider the establishment of an internal audit function, it still remains voluntary. Few studies have investigated voluntary demand for internal auditing in the US (Wallace and Kreuzfeldt, 1991) and Australia (Anderson et al., 1993; Carey et al., 2000), illustrating the relevance of agency variables. Recently, Sarens (2007) found that agency variables are highly relevant when explaining the size of the internal audit function within Belgian companies. It was confirmed that the more diffused the ownership structure of the company, the larger the company and the more reporting levels within the company, the larger the internal audit function.

Complementary to existing explanatory models, recent studies in this area (cf. Goodwin-Stewart and Kent, 2006; Sarens and De Beelde, 2006a; 2006b) describe the growing influence of the control environment on internal auditing practices. This study develops three variables reflecting the control environment in which internal audit functions are operating, and tests whether these variables can be associated with the size of the internal audit function. These new variables better fit with the increased attention for risk management and internal control and the growing role of internal auditing in these areas. Given the exploratory character of these variables, this paper opens new ways of conducting research on internal auditing



characteristics. These variables also offer practitioners a tool to evaluate and benchmark the size of their internal audit function based on specific characteristics of their control environment.

The results of this study confirm the relationship between the control environment and the size of the internal audit function. It is shown that the degree of formalisation of the risk management system and the risk culture are positively associated with the size of the internal audit function. Besides, interesting differences appear between the smallest and the largest companies in this study.

The remainder of this paper is structured as follows. The second section describes the control environment variables and develops hypotheses based on a review of the literature. The third section outlines the methodology of this study. The fourth section presents the empirical results. Finally, the paper ends with a summary and discussion of the conclusions.

## **DEVELOPMENT OF CONTROL ENVIRONMENT VARIABLES AND HYPOTHESES**

The study by Wallace and Kreutzfeldt (1991) is among the first to demonstrate the importance of control environment characteristics in explaining the existence of an internal audit function. More than ten years later, Goodwin-Stewart and Kent (2006) elaborate on this idea. They take into account factors related to risk management and internal control. When explaining the existence of an internal audit function within Australian companies, they found that the existence of an internal audit function is positively associated with the use of a separate risk management committee and the use of a designated risk manager. These results suggest that firms with an integrated risk management framework are more likely to have an internal audit function, and that internal auditing is complementary to other risk management mechanisms.

Recent case based research studies on internal auditing in Belgium illustrate the importance of the control environment. Sarens and De Beelde (2006b) found that the tone-at-the-top and the control awareness are important when studying internal auditing practices. Another recent study by Sarens and De Beelde (2006a) revealed that the status of the risk management system has a strong impact on the role of internal auditing within an organisation. Factors

that turned out to affect internal auditing are: the level of risk and control awareness, the degree of formalisation of the risk management system, the extent to which responsibilities related to risk management and internal controls are clearly defined and communicated, and the existence of a separate risk management function.

The risk management environment seems to have an important effect on how the internal audit function operates within an organisation (Selim and McNamee, 1999b; Spira and Page, 2003). The description of the control environment provided by the Enterprise Risk Management framework (ERM, 2004) is used as the basis for this study. The ERM framework (2004) describes the control environment of a company as:

“...the foundation for all other components of enterprise risk management, providing discipline and structure. The internal environment influences how strategy and objectives are established, business activities are structured and risks are identified, assessed and acted upon. It influences the design and functioning of control activities, information and communication systems, and monitoring activities”.

This description suggests that the control environment has an influence on all other components of a risk management system, and thus, also on internal auditing. Internal auditing plays a crucial monitoring role with respect to risk management and internal control systems, as clearly outlined by the IIA (2004) and confirmed by recent studies (Allegrini and D’Onza, 2003; Paape et al., 2003; Sarens and De Beelde, 2006a; Spira and Page, 2003). Given these indications, this study has the intention to develop three variables reflecting different dimensions of the control environment. Three hypotheses will test the relationship between these variables and the size of internal audit functions.

### **Tone-at-the-Top**

According to the ERM framework (2004), the tone-at-the-top is an important element of the control environment. This refers to a company’s ethical values, management’s philosophy and operating style (Cohen et al., 2002) which are reflected by the company’s code of conduct or code of ethics. Schein (1990) suggests that the modelling by leaders and powerful organisational members enables other group members to identify with them and internalise their values and assumptions. Sarens and De Beelde (2006b) examine the influence of the tone-at-the-top on the scope of internal audit activities. Based on this study, it can be reasonably assumed that when the company pursues integrity and clear ethical values and when management shows integrity in its philosophy and operating style, the independent and

objective monitoring role of internal auditing will take on greater importance. This can be seen as a way of translating and communicating the tone-at-the-top throughout the company. Furthermore, Sarens and De Beelde (2006a; 2006b) show that risk and control awareness at management level is another element that can be considered as part of the tone-at-the-top, and that has an influence on the scope of internal audit work. It can be assumed that the more management is aware of risks and controls, the more they will appreciate internal auditing's supportive role in monitoring and improving risk management and internal control. Consequently, we formulate the following hypothesis:

Hypothesis 1: A more supportive tone-at-the-top in the company is associated with a larger internal audit function.

### **Formalisation of the Risk Management System**

In addition to the overall risk and control awareness within the company, Sarens and De Beelde (2006a) and Selim and McNamee (1999b) demonstrate the relationship between the status of the risk management system and internal audit activities. A company with a more formalised risk management system, in which the responsibilities are clearly defined, is a more supportive environment for internal auditing. The more formalised the risk management system, the more the systematic and disciplined assurance and consulting role of internal auditing in evaluating and improving the risk management system will be valued. Following Goodwin-Stewart and Kent (2006) and Selim and McNamee (1999b), who both found that risk management functions interact with internal auditing, the existence of a separate risk manager or risk management function, as part of the overall risk management system, will presumably enhance the role of internal auditing. It can be argued that a separate risk manager, supporting management in their risk management responsibilities, will more appreciate the complementary role of internal auditing in monitoring and improving the risk management system. We will test the following hypothesis:

Hypothesis 2: A more formalised risk management system is associated with a larger internal audit function.

### **Risk Culture**

Selim and McNamee (1999a) found that an organisation's culture is greatly influenced by the tacit acceptance that business risks, both in their negative and positive facets, are paramount

in all decisions relating to the strategic and tactical levels. As described by the ERM framework (2004), the risk culture characterises how a company considers risk in its day-to-day activities, the extent to which the company seeks out or avoids high risk projects or solutions in its day-to-day activities. For many companies, the risk culture flows from the company's risk appetite, influencing the final extent of risk a company wants to accept when pursuing its goals and objectives. Companies with a higher (lower) risk appetite will more (less) actively look for high risk projects or solutions. It would be expected that in a high-risk culture, the probability of a fraud case will be enhanced. Selim and McNamee (1999a) found empirical evidence that the risk culture cascaded down the organisational structure to include managers at all levels. By implication, this can be internal auditing. It is supposed that within a high-risk culture, internal auditing can play a more value adding role in monitoring risk taking and the way of managing risks as well as looking for potential fraud indicators resulting from this high risk-taking behaviour. This leads to a third hypothesis.

Hypothesis 3: A higher risk culture in the company is associated with a larger internal audit function.

## METHODOLOGY

### **Target Population**

Our target population consists of two groups of companies. The first is banks and insurance companies, as they have internal audit functions in order to comply with regulatory requirements (Basel Committee, 2001). The second, based on the membership database of the Belgian Institute of Internal Auditors (IIABEL), consists of manufacturing and service companies that have an internal audit function. This results in a target population of 260 companies.

### **Data Collection**

Data for this study were collected using a questionnaire based on literature and pre-tested with nine experienced Chief Audit Executives<sup>17</sup>. This questionnaire was e-mailed in November 2005 to the head of the internal audit department of all 260 companies from the target

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<sup>17</sup> Note that all these Chief Audit Executives have more than 15 years of experience in internal auditing. Three of them are working in a financial company (bank and insurance) and six are working in a non-financial company.

population. By March 2006, after an intensive follow-up by e-mail and phone<sup>18</sup>, 85 questionnaires were returned (overall response rate of 32.69 percent). After leaving out 12 questionnaires containing many missing values, the final count of usable questionnaires was 73. This represents 28.08 percent of the target population, which is comparable to recent studies in this area (e.g. Carcello et al., 2005a, Mat Zain et al., 2006).

### **Non-Response Bias**

To detect a possible non-response bias, Armstrong and Overton (1977) suggest comparing key constructs between early and late respondents<sup>19</sup>. The analysis reveals no significant differences in terms of number of employees ( $p = .702$ ) and total assets (.109) between early and late respondents. Comparing the size of the internal audit function and the control environment variables did not show significant differences between early and late respondents. It can be concluded that the data do not suffer from a non-response bias.

### **Size of the Internal Audit Function**

Respondents were asked to indicate the number of internal auditors (FTE) in their internal audit department.

### **Company Size**

Consistent with previous research, total assets as stated in the 2005 annual report are used to measure company size (cf. Carey et al., 2000; Chow, 1982; Sarens, 2007; Wallace and Kreutzfeldt, 1991).

### **Operationalization of the Control Environment Variables**

Table 1 gives an overview of the different items for each of the three variables and the results of the factor analysis (Varimax). Together, these three variables account for 69 percent of the total variance. All items were measured through the questionnaire using a Likert scale ranging from one (strongly disagree) to five (strongly agree). The first variable (Tone-at-the-Top) is measured using four items based on the ERM framework (2004) as well as previous research done by Sarens and De Beelde (2006a; 2006b). It has a Cronbach's alpha of 0.85, which is quite high for a new developed measure. The second variable (Formalisation of the

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<sup>18</sup> We gratefully acknowledge the assistance of IIABEL in this part of the data collection.

<sup>19</sup> We consider those respondents returning their questionnaire during the last week of the data collection, who lasted 18 weeks in total, as 'late respondents'.

Risk Management System) is measured using three items based on Goodwin-Stewart and Kent (2006) and Sarens and De Beelde (2006a), resulting in a sufficiently reliable measure (Cronbach's Alpha = 0.74). The third variable (Risk Culture) is measured based on three items inspired by the ERM framework (2004). The reliability of this measure is still acceptable (Cronbach's Alpha = 0.66) given the exploratory character of this study. For each variable, the average of the items was calculated and will be used in further analysis.

[INSERT TABLE 1 HERE]

## EMPIRICAL RESULTS

### Descriptive Statistics

Panel A of Table 2 shows a breakdown of the respondents by industry. It becomes clear that almost one third (32 percent) of the respondents comes from the production, energy and utility sector, whereas one fourth (26 percent) of the respondents operates in the financial sector (bank or insurance company). Panel B of Table 2 divides the respondents into three groups based on their size (total assets). A first group contains the relatively smaller companies (total assets < 500 million Euro) and represents about 29 percent of the respondents. A third group contains the largest companies (total assets > 7.5 billion Euro) and represents 22 percent of the respondents. Almost half of the respondents (49 percent) falls within the middle group.

Table 3 reveals substantial variability in the number of internal auditors, ranging from 1 to 130, with a mean of about 11 internal auditors. The scores for the control environment variables show that the tone-at-the-top is supportive (overall average score above 4) in 73 percent of the responding companies. This is supported by an average score of 4.07. The risk management system of the responding companies is, on average, somewhat formalised (average score of 3.14). Only 34 percent of the responding companies has a formalised risk management system (overall average score above 4). Overall, the culture seems to be relatively risk averse (average score of 2.92). Only one fourth (26 percent) of the companies has a high risk culture (overall average score above 4).

[INSERT TABLE 2 HERE]

[INSERT TABLE 3 HERE]

### **Correlations and Significance Tests**

Table 4 gives of an overview of the correlations when taking into account all respondents. Consistent with previous research (Abdel-Khalik, 1993; Anderson et al., 1993; Chow, 1982; Sarens, 2007) the size of the internal audit function is strongly positively correlated ( $p < .01$ ) with the company size.

Besides, the correlation matrix indicates a significantly positive correlation ( $p < .01$ ) between the formalisation of the risk management system and the size of the internal audit function. An ANOVA test reveals a significantly larger internal audit function in those companies with a formalised risk management system ( $F = 12.594$ ;  $p < .01$ ). This result confirms the second hypothesis and indicates that a more formalised risk management system is associated with a larger internal audit function. It is suggested that a more formalised risk management system in which responsibilities are clearly defined and in which a separate risk manager or risk management function exists, can be considered as a more supportive environment for internal auditing (Sarens and De Beelde, 2006a). This is reflected in a larger internal audit function. Furthermore, this result is consistent with previous findings of Goodwin-Stewart and Kent (2006) and Selim and McNamee (1999b), indicating the complementary role between the internal audit function and the risk manager.

[INSERT TABLE 4 HERE]

A closer investigation of Table 4 reveals that the formalisation of the risk management system is significantly positively related ( $p < .01$ ) with the company size and the tone-at-the-top. A more formalised risk management system is associated with larger companies and a more supportive tone-at-the-top.

Company size seems to be a dominant variable. Therefore, the group of respondents is divided into three sub-groups based on the company size (cf. Panel B of Table 2). Table 5 shows the correlation matrix for the smallest companies (total assets < 500 million Euro). The size of the internal audit function is only significantly positively ( $p < .05$ ) correlated with the formalisation of the risk management system. This is supported by an ANOVA test indicating a significantly larger internal audit function ( $F = 5.867$ ;  $p < .05$ ) in those companies with a formalised risk management system. Within the smallest companies, the formalisation of the risk management is not significantly correlated with other variables.

[INSERT TABLE 5 HERE]

Table 6 shows the correlation matrix for the largest companies (total assets > 7.5 billion Euro). Contrary to the smallest companies, the size of the internal audit function is only significantly positively ( $p < .01$ ) correlated with the risk culture. This is supported by an ANOVA test revealing a significantly larger internal audit function ( $F = 4.421$ ;  $p = .05$ ) in those companies with a high risk culture. A further investigation of Table 6 shows a significantly positive correlation ( $p < .05$ ) between the risk culture and the company size. It seems that, within this group, the largest companies are associated with a higher risk culture.

[INSERT TABLE 6 HERE]

Table 7, showing the correlation matrix for all other companies that fall within the middle group (total assets > 500 million Euro and < 7.5 billion Euro), reveals no significant correlation between the size of the internal audit function and neither with the control environment variables, nor with the company size.

[INSERT TABLE 7 HERE]

## **DISCUSSION AND CONCLUSION**

In this paper, three control environment variables were developed and their relationship to the size of the internal audit function was tested. In contrast to previous research, incorporating single characteristics of the control environment (cf. Goodwin-Stewart and Kent, 2006; Wallace and Kreutzfeldt, 1991), this study reflects different dimensions of the control environment measured by well-considered items. The operationalisation of this new model was inspired by the ERM framework (2004) and recent findings on internal auditing in Belgium (Sarens and De Beelde, 2006a; 2006b). It can be concluded that some characteristics of the control environment are significantly correlated with the size of the internal audit function. This alternative approach opens new areas for further research.

The results suggest that companies with a more formalised risk management system have a larger internal audit function. Given previous research (Goodwin-Stewart and Kent, 2006; Sarens and De Beelde, 2006a), this may lead to the conclusion that the monitoring role of



internal auditing with respect to risk management and internal controls is more valued in companies that adopt a formalised risk management approach. A company in which risk management responsibilities are clearly defined and communicated and a separate risk management function exists, would be a more supportive environment for the development of the internal audit function.

Further analysis indicates a significant positive relationship between the tone-at-the-top and the degree of formalisation of the risk management system. This suggests that when a company pursues integrity and clear ethical values, and when management has an honest philosophy and operating style, combined with a high level of risk and control awareness, a more formalised risk management system will be implemented. Further research could elaborate on this by investigating whether the following assumption makes sense: the more supportive the tone-at-the-top, the more formalised the risk management system, and consequently, the larger the internal audit function. In other words, could the formalisation of the risk management system be considered as an intermediate variable?

Further examination also reveals a significant positive correlation between company size and the degree of formalisation of the risk management system, suggesting that larger companies are likely to have a more formalised risk management system. Given previous research indicating the positive relationship between company size and the size of the internal audit function (Sarens, 2007), one can wonder whether the degree of formalisation of the risk management system is an intermediate variable between the company size and the size of the internal audit function. Can it be assumed that larger companies are more likely to have a formalised risk management system, and therefore, are more likely to appreciate the monitoring role of internal auditing with respect to risk management and internal controls? This may suggest that the control environment variables are, to some extent, complementary to the agency model adopted by previous studies in this area (Abdel-Khalik, 1993; Anderson et al., 1993; Carey et al., 2000; Sarens, 2007; Wallace and Kreutzfeldt, 1991). Further research could elaborate on this relationship.

Further analysis suggests that the control environment variables are more relevant when investigating the size of the internal audit function within the smallest and largest companies in this study. It was found that the size of the internal audit function within the smallest companies is strongly related with the degree of formalisation of the risk management system.

Within smaller companies, the degree of formalisation of the risk management system can vary much more (cf. Sarens and De Beelde, 2006a), and therefore, it seems reasonable that it has a more significant influence on the size of the internal audit function. As soon as the company reaches a certain size, a formalised risk management system becomes more common. Therefore, it can be assumed that the influence of the formalisation of the risk management system on the size of the internal audit function becomes less significant when the company becomes larger. This may suggest that company size could be considered as a moderating variable between the formalisation of the risk management system and the size of the internal audit function.

Within the largest companies, the size of the internal audit function is strongly associated with the risk culture of the company. This suggests that, within the largest companies, the role of internal auditing in monitoring risk taking, and the related internal controls as well as its potential role in detecting fraud become more important. Furthermore, it was suggested that, within this group of largest companies, the risk culture becomes even higher when the company continues to grow. Or is it the other way around? In other words, does a company grow thanks to a higher risk culture, which in its turn, leads to a larger internal audit function? Nevertheless, it can be assumed that the influence of the risk culture on the size of the internal audit function becomes more significant when the company becomes larger. Again, this may suggest that company size could be considered as a moderating variable.

Figure 1 summarises the relationships that were supported by this study, without indicating any direction. Figure 2 presents the assumed relationships and their direction, which could become the focus of further research.

### **Limitations**

Although providing interesting exploratory evidence, this study is merely a first attempt to come up with alternative explanations for the size of the internal audit function. More conclusive statistical techniques need to be performed in order to conclude on the direction of each of the assumed relationships. Further research could also improve the operationalisation of the current variables to increase their explanatory power. Adding new constructs, for example, characteristics of the board and/or the audit committee, could further enhance the relevance of this control environment approach in explaining the size of the internal audit function. Besides the size the internal audit function, further research could also apply these

control environment variables to explain specific internal audit practices, such as the involvement in the formalisation of the risk management and internal control system, measured as a percentage of the annual working time.

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**Table 1: Control Environment Variables**

<b>Measures and Items</b>	<b>Alpha</b>	<b>Factor Loading</b>	<b>Source (based on)</b>
<b><i>Tone-at-the-Top</i></b>	.848		
We pursue formalised integrity and clear ethical values		.881	ERM framework (2004); Sarens and De Beelde (2006a; 2006b)
Management has an integer philosophy and operating style		.744	
There exists a code of conduct and/or code of ethics		.852	
There is a high level of risk and control awareness at management level		.783	
<b><i>Formalisation of the Risk Management System</i></b>	.739		
A formal risk management system is used within our company		.887	Sarens and De Beelde (2006a); Goodwin-Stewart and Kent (2006)
Responsibilities related to risk management and internal controls are clearly defined within our company		.769	
There exists a separate risk manager or risk management function within our company		.740	
<b><i>Risk Culture</i></b>	.660		
In our company, it is common to avoid risks		.714	ERM framework (2004)
Management avoids high risk projects or solutions		.852	
There did not happen any serious fraud case during the last five years		.734	

**Table 2 : Breakdown of the Respondents**

	<b>Frequency</b>	<b>Percentage</b>
<b><i>Panel A : Industry</i></b>		
Production, energy, utilities	23	31.50%
Telecom, IT, media, entertainment	9	12.33%
Trade, Transport, logistics	9	12.33%
Professional services	13	17.81%
Financial services and insurances	19	26.03%
	73	100%
<b><i>Panel B: Company Size (Total Assets in thousand Euro)</i></b>		
< 500 000 Euro	21	28.77%
500 000 – 7 500 000 Euro	36	49.31%
> 7 500 000 Euro	16	21.92%
	73	100%

**Table 3: Descriptive Statistics (n = 73)**

	<b>Min.</b>	<b>Max.</b>	<b>Mean</b>	<b>S.D.</b>
Number of internal auditors	1	130	10.71	21.19
Tone-at-the-top	1	5	4.07	0.99
Formalisation of the risk management system	1	5	3.14	1.24
Risk culture	1	5	2.92	1.05

**Table 4: Correlation Matrix (all companies)**

	Number_IA	Total_Assets	Tone_at_the_Top	Formalisation	Risk_Culture
Number_IA	1				
Total_Assets	.522**	1			
Tone_at_the_Top	.167	.193	1		
Formalisation	.371**	.315**	.428**	1	
Risk_Culture	.178	.193	-.205	-.009	1

\* : p <.05      \*\* : p <.01



**Table 5: Correlation Matrix (smallest companies)**

	Number_IA	Total_Assets	Tone_at_the_Top	Formalisation	Risk_Culture
Number_IA	1				
Total_Assets	.222	1			
Tone_at_the_Top	.091	.245	1		
Formalisation	.484*	.102	.431	1	
Risk_Culture	.085	.068	-.277	-.159	1

\* : p < .05      \*\* : p < .01

**Table 6: Correlation Matrix (largest companies)**

	Number_IA	Total_Assets	Tone_at_the_Top	Formalisation	Risk_Culture
Number_IA	1				
Total_Assets	.377	1			
Tone_at_the_Top	.105	.347	1		
Formalisation	.260	.347	.445	1	
Risk_Culture	.653**	.531*	.359	.064	1

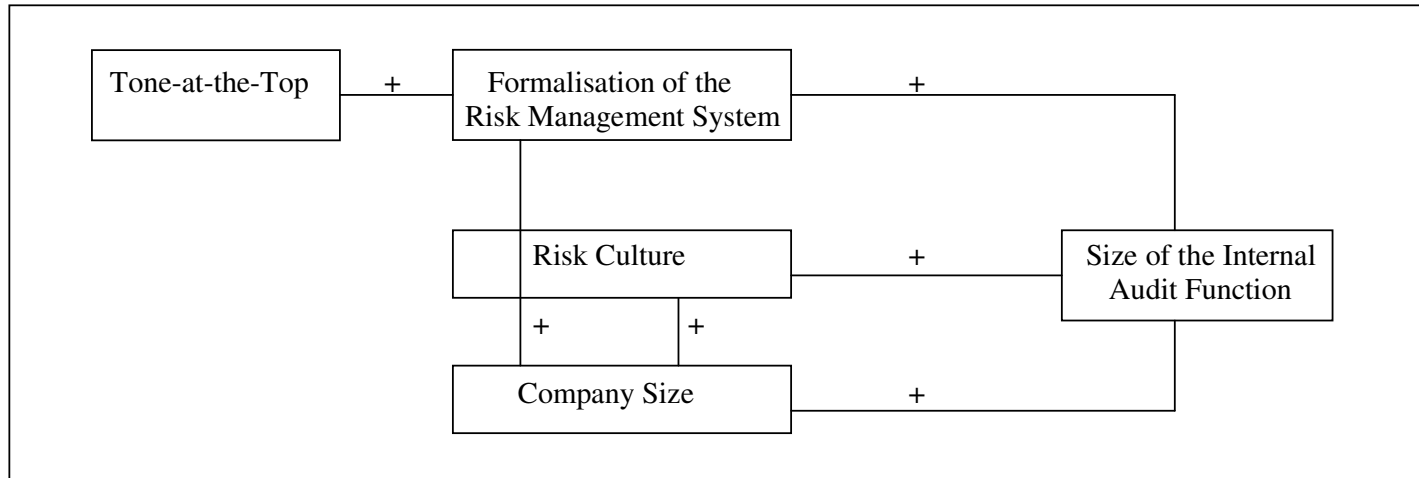
\* : p <.05      \*\* : p <.01

**Table 7: Correlation Matrix (middle group)**

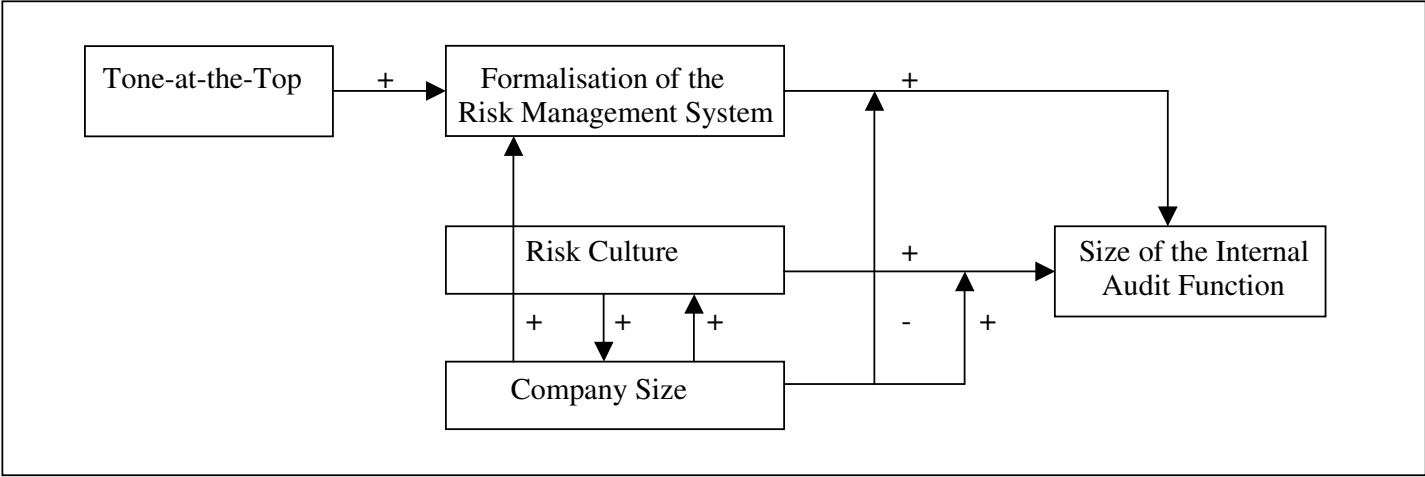
	Number_IA	Total_Assets	Tone_at_the_Top	Formalisation	Risk_Culture
Number_IA	1				
Total_Assets	.190	1			
Tone_at_the_Top	-.180	.095	1		
Formalisation	.073	.282	.593	1	
Risk_Culture	-.058	.210	-.262	.146	1

\* : p <.05      \*\* : p <.01

**Figure 1: The Relationship between the Control Environment and the Size of the Internal Audit Function (Supported Associations)**



**Figure 2: The Relationship between the Control Environment and the Size of the Internal Audit Function  
(Assumed Direction of the Relationships)**











## **CONCLUSION**



## CONCLUSION

This dissertation, consisting of six related papers, dealt with two research questions. First, the size of the internal audit function (macro level) was explained, and second, organisational variables, influencing internal audit practices (micro level) were studied. Overall, this dissertation provided a comprehensive picture of the internal audit profession.

This dissertation contributes to the academic literature by positioning internal audit in the contemporary corporate governance context, a context that has changed a lot during the past decade. As a consequence, the role of internal audit in corporate governance has also changed significantly, creating a need for updated and refined research and theory specification. Contrary to most academic research on internal audit, this dissertation studied internal audit in a continental European context in which corporate governance requirements are less stringent, compared to an Anglo-Saxon context. This creates a unique context in which, for a majority of companies, the establishment of an internal audit function still remains voluntary.

In this dissertation, a unique mix of theories was used to enhance the understanding of internal auditing and specify an advanced theoretical framework to study the role of internal audit in corporate governance, something that was missing until now. More specifically, agency theory, sociology of professions theory and applied psychological theory were combined with insights from previous empirical research on internal audit, the Standards for the Professional Practice of Internal Audit and current corporate governance guidelines and best practices. Studying the empirical data from such a rich theoretical point of view created many new insights that contribute both to the academic literature in this area as well as to the development of the internal audit profession. In order to attain the overall goal of this dissertation to provide a comprehensive picture of the internal audit profession, a balanced combination of qualitative and quantitative data was used, leading to sound and well-founded conclusions.

Appendix 4 reviews the key constructs of this dissertation, linked with the six papers.

At the macro level, this dissertation explained the size of the internal audit function from two different theoretical approaches. Traditional agency theory was validated as a relevant explanation for the size of the internal audit function. More specifically, internal audit turned

out to be an important monitoring mechanism in reducing information asymmetries stemming from the separation of ownership and control of companies, a problem that can be considered as the root of corporate governance principles. Furthermore, it turned out that internal audit is also a mechanism to reduce internal information asymmetries between those who delegate responsibilities (senior management) and those who assume these responsibilities (lower management). More specifically, the size of the internal audit function seemed to be positively related to the size of the company and the number of reporting levels within the company. Keeping these findings in mind, one can wonder why current corporate governance guidelines and recommendations in Belgium, as well as in other European countries, only limitedly focus on the monitoring role of internal audit in corporate governance. This dissertation illustrated that a well-developed internal audit function seems to be a necessary element to achieve good corporate governance. Without falling into the extreme of making an internal audit function mandatory (e.g. NYSE listed companies), corporate governance guidelines and recommendations should definitely stimulate more intensively the establishment and development of an internal audit function and highlight its key role in monitoring risk management, internal control and governance. This will not only benefit corporate governance, but, also, increase the maturity of the internal audit profession.

Complementary to agency theory, this dissertation specified three new control environment variables (tone-at-the-top, formalisation of the risk management system and risk culture) offering alternative explanations for the size of the internal audit function. Empirical tests demonstrated that a more formalised risk management system, as well as a higher risk culture within the company, are associated with a larger internal audit function. This alternative theoretical approach opens new ways to study the importance of internal audit and fits within the increased attention to risk management and internal control as crucial parts of corporate governance. Future research could refine these variables and add new dimensions of the control environment to this research model in order to enhance its relevance and explanatory power. It can be argued that a stronger focus of corporate governance guidelines and best practices on the importance of risk management and internal control, as well as a more detailed specification of the responsibilities of the board of directors (audit committee) and executive management within this area, would stimulate companies to further develop and formalise their risk management and internal control system. This would contribute to good corporate governance and create a more supportive environment for the development of the internal audit function. Given its crucial role in risk management and internal control,

internal audit would benefit from an increased attention to risk management and internal control in corporate governance guidelines and recommendations.

Besides explaining the size of the internal audit function, this dissertation specified new organisational variables that influence internal audit practices (micro level). Well-considered case studies specified the influence of three organisational variables: the stakeholders of internal audit, the risk management and internal control system and the organisational support for internal audit. Basically, it was found that internal audit practices should be studied from the two-way interaction between internal audit and its two major stakeholders, the audit committee (as a sub-committee of the board of directors) and senior management. This dissertation clearly demonstrated that this two-way interaction is characterised by, on the one hand, the search for comfort by the audit committee and senior management, and, on the other hand, the provision of comfort by internal audit. More specifically, the needs of the internal audit's stakeholders for comfort turned out to be influenced by the corporate governance context imposing specific requirements with respect to financial reporting, risk management and internal control, as well as the status of the risk management and internal control system.

Overall, stakeholders need comfort on the control environment of the company and expect internal audit to be the 'guard of the corporate culture'. Furthermore, stakeholders want internal audit to be a supporting function, instead of purely a control function. Internal audit creates this comfort by providing its stakeholders with an independent evaluation of the effectiveness and efficiency of processes and internal controls, combined with recommendations to improve their effectiveness and efficiency. It has been illustrated that more stringent corporate governance requirements, such as internal control review and disclosure requirements (e.g. Sarbanes Oxley Act), stimulate stakeholders to look more actively for internal audit's objective evaluations and opinions as a basis to fulfil their responsibilities. Moreover, a less developed and formalised risk management and internal control system creates specific feelings of discomfort on behalf of the audit committee and senior management. Consequently, internal audit's active supporting role in the formalisation of the risk management and internal control system creates a significant level of comfort for the audit committee and senior management. It has been found that internal audit's unique knowledge, consisting of general conceptual knowledge combined with more specific company-related and practical knowledge on processes, procedures, risk management and internal controls, forms the basis to provide comfort.

The case studies indicated that internal audit's stakeholders reciprocate this comfort by providing them with the necessary support. It turned out that this organisational support is strongly influencing the acceptance and appreciation of the internal audit function within the company, and, as a consequence, also internal audit practices. More specifically, this support is translated into input for the annual audit planning, ad hoc requests, attention paid to the results of internal audit, follow-up of recommendations and action plans and support for the expansion of the internal audit function. Indications were found that the recent increased attention to corporate governance has contributed to increased organisational support for internal audit, which can be explained by the significant level of comfort that internal audit can provide to its stakeholders.

In addition to its academic contribution, this dissertation adds value to the development of the internal audit profession. It has to be stressed that this dissertation was realised thanks to an intensive collaboration with practitioners and, therefore, it would be an honour for me to reciprocate their willingness to provide data for this research. This dissertation offers valuable benchmarking information on current best practices. In particular, the insights of this dissertation enable practitioners to evaluate the size of their function and their current activities based on the specific influence of stakeholders, such as the audit committee and senior management, or the specific characteristics of the control environment in which they are working. Moreover, the conclusions of this dissertation provide guidance on how to strengthen their position within the contemporary corporate governance field and, thereby, enhance their added value for the company.

It should be noted that each of the research methods applied in this dissertation has its limitations. Qualitative samples have the intention of being purposive instead of random. Therefore, the conclusions resulting from these case studies can not be generalised, but need to be interpreted as specifying new theoretical concepts and relationships. Moreover, the selection of cases is partially theoretically driven and partially based upon experience with the internal audit profession. Besides, only a limited number of people were interviewed, thereby focusing on the perceptions of internal auditors, audit committee members and senior managers. Further research could take into account the perceptions of other stakeholders, such as lower managers. With respect to the quantitative data, it needs to be stressed that, in paper one, proxies were used to measure independent variables, such as diffusion of ownership and geographical dispersion of the activities. Besides, the measurement of the

control environment variables in paper six is based upon subjective assessments made by the responding Chief Audit Executives. It would be an interesting challenge for further researchers to come up with more objective measures for these control environment variables.

Given that the influence of the organisational variables has been studied at the level of internal audit practices, further research could extrapolate these conclusions to the broader corporate governance field and investigate to what extent comfort provided by internal audit leads to improved performance by the board of directors and audit committee, or increased quality in financial reporting. When elaborating on these interesting topics, researchers could contribute to the theory and literature in each of these specific research areas by applying the theoretical insights of this dissertation. The case studies also indicated that internal audit's stakeholders, especially the audit committee, often rely on other sources of comfort such as the external auditor. Indications were found that an intensive collaboration between internal and external audit can significantly enhance the overall level of comfort for the audit committee. Therefore, it could be an interesting challenge to elaborate further on this idea and investigate whether this collaboration enhances, for example, overall audit quality. A quantitative approach, relying on, for example, a combination of archival and questionnaire data, seems to be an appropriate way to study this relationship.

As this dissertation mainly focuses on the specific needs for comfort of internal audit's stakeholders and how internal audit can provide this comfort, this dissertation ignores the specific motivations and incentives that stimulate audit committee members and senior managers to seek this comfort. In this dissertation, it is assumed that feelings of discomfort were created by enhanced corporate governance requirements imposed on the audit committee and senior management. Nevertheless, it can be argued that more specific personal motivations underlie the behaviour of audit committee members and senior managers in assuming their responsibilities and seeking for comfort. Therefore, a whole new research area, combining the theoretical contributions of this dissertation with concepts from management control literature, still remains unexplored and is, as a consequence, an attractive way to contribute to the literature. Consistent with the methodological approach of this dissertation, further research in this area could use qualitative data in a first step to explore this new dimension, followed by quantitative data collected on a larger scale to validate conclusions.

To end with, I want to adjust a quote mentioned in paper two: “The area of internal auditing is *still* ripe for a wide variety of research (Rittenberg, 1999; 35)”.







## **APPENDICES**



**Appendix 1: Overview of the Six Papers (Subject and Research Method)**

	<b>Paper 1</b>	<b>Paper 2</b>	<b>Paper 3</b>	<b>Paper 4</b>	<b>Paper 5</b>	<b>Paper 6</b>
<b>Subject</b>	Agency Model to Explain the Size of the Internal Audit Function	Three Organisational Variables that Influence Internal Auditing Practices	Role of Internal Audit in Risk Management	Relationship between Internal Audit and the Audit Committee	Relationship between Internal Audit and Senior Management	Relationship between Control Environment and Size of the Internal Audit Function
<b>Research Method</b>	Questionnaire + Annual Reports	6 Case Studies: Cases 1 to 6	10 Case Studies: Cases 7 to 16	4 Case Studies: Cases 6, 14, 16, 17	5 Case Studies: Cases 6, 14, 16, 17, 18	Questionnaire

## Appendix 2: Overview of the 18 Cases

	Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
<b>Year</b>	2004	2004	2004	2004	2004	2004 – 2005
<b>Sector</b>	Services	Manufacturing	Services	Manufacturing	Banking and Insurance	Manufacturing
<b>Employees</b>	1 000 – 5 000	5 000 – 10 000	1 000 – 5 000	1 000 – 5 000	> 10 000	> 10 000
<b>Listing</b>	Euronext Paris Deutsche Börse Frankfurt	Euronext Brussels Euronext Paris	None	Euronext Brussels	Euronext Brussels	Euronext Brussels
<b>Age of the internal audit function*</b>	2 years	12 years	13 years	1 year	> 20 years	> 20 years
<b>Number of internal auditors (FTE)*</b>	1	2	3	1	300	8
<b>Interviewee(s)</b>	Internal Auditor	Internal Audit Manager	Internal Audit Director	Internal Auditor	Internal Audit Manager	Internal Audit Manager Audit Committee Chair Chief Financial Officer

\*: when the case study was conducted

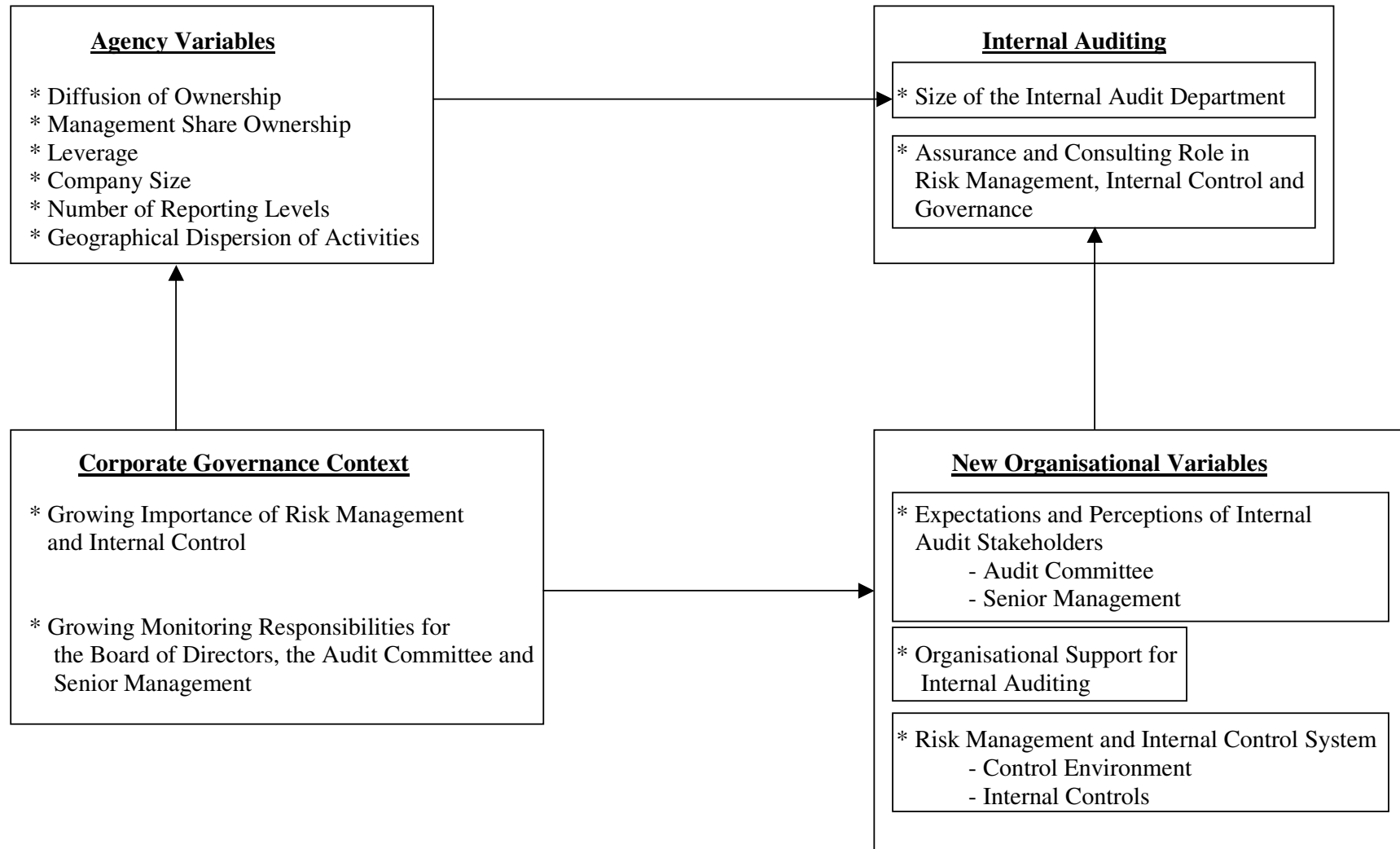
	Case 7	Case 8	Case 9	Case 10	Case 11	Case 12
<b>Year</b>	2004	2004	2004	2004 – 2005	2004	2004
<b>Sector</b>	Manufacturing	Manufacturing	Services	Manufacturing	Services	Services
<b>Employees</b>	> 10 000	> 10 000	> 10 000	5 000 – 10 000	> 10 000	> 10 000
<b>Listing</b>	Euronext Brussels	New York Stock Exchange	Euronext Brussels	Euronext Brussels	New York Stock Exchange	New York Stock Exchange
<b>Age of the internal audit function*</b>	10 years	25 years	10 years	7 years	10 years	30 years
<b>Number of internal auditors (FTE)*</b>	7	120	20	2	6	50
<b>Interviewee(s)</b>	Chief Audit Executive	Internal Audit Manager	Chief Audit Executive	Internal Auditor	Internal Audit Manager	Internal Audit Manager

\*: when the case study was conducted

	<b>Case 13</b>	<b>Case 14</b>	<b>Case 15</b>	<b>Case 16</b>	<b>Case 17</b>	<b>Case 18</b>
<b>Year</b>	2004	2004 - 2005	2004	2004 – 2005	2005	2005
<b>Sector</b>	Services	Manufacturing	Manufacturing	Services	Services	Services
<b>Employees</b>	> 10 000	1 000 – 5 000	1 000 – 5 000	1 000 – 5 000	1 000 – 5 000	1 000 – 5 000
<b>Listing</b>	New York Stock Exchange	Euronext Brussels	Euronext Brussels	Euronext Brussels	None	Euronext Brussels
<b>Age of the internal audit function*</b>	35 years	15 years	2 years	> 15 years	1 year	13 years
<b>Number of internal auditors (FTE)*</b>	14	1	2	1	1	3
<b>Interviewee(s)</b>	Internal Audit Manager	Internal Auditor Audit Committee Chair Chief Financial Officer	Internal Audit Manager	Internal Auditor Audit Committee Chair Chief Financial Officer	Internal Auditor Audit Committee Chair Chief Executive Officer	Internal Audit Manager Chief Executive Officer

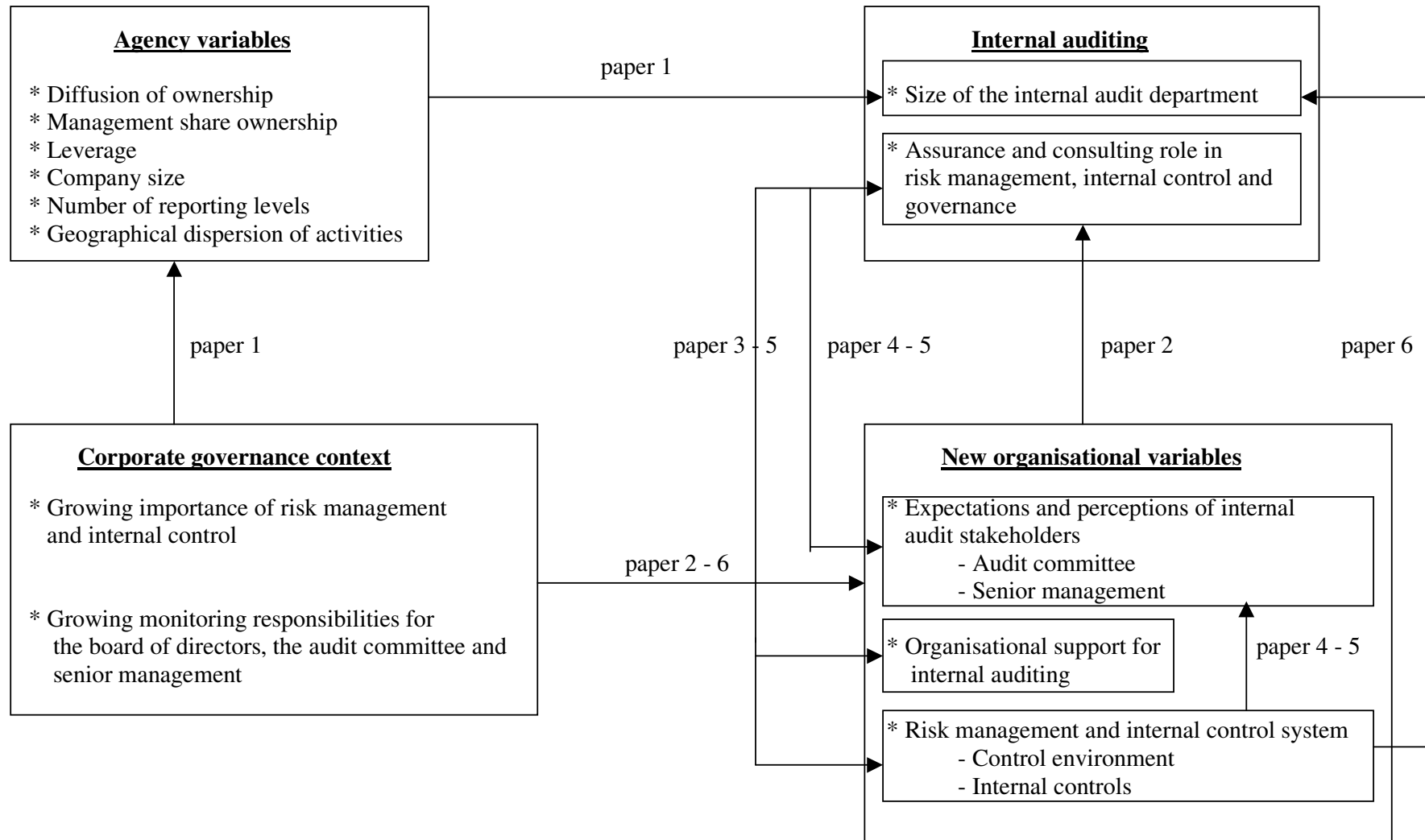
\*: when the case study was conducted

### Appendix 3: Overview of the Key Constructs





**Appendix 4: Overview of the Key Constructs linked with the Six Papers**









## **CURRICULUM VITAE**

Gerrit Sarens (°Dendermonde, 1981) obtained his Master's degree in Applied Economics from Ghent University in 2003. Since October 2003, he is working as doctoral researcher, under the supervision of Prof.dr. Ignace De Beelde, at the department of Accountancy and Corporate Finance, where he is conducting research in the area of internal audit. During his doctoral project, he attended several doctoral courses at the European Institute of Advanced Studies in Management (EIASM), the Institute of Continuing Education, London School of Economics and the Netherlands Organisation for Research in Business Economics and Management (NOBEM). Several papers have been presented at international conferences and workshops (EIASM Workshop on Audit, European Academic Conference on Internal Audit and Corporate Governance, Annual Congress of the European Accounting Association and European Audit Research Network Symposium). In 2006, he participated at the Doctoral Colloquium of the European Accounting Association and obtained the best paper price at the European Academic Conference on Internal Audit and Corporate Governance. Three papers of this dissertation have been published in international academic journals (International Journal of Accounting, Auditing and Performance Evaluation; Managerial Auditing Journal and International Journal of Auditing).

