8 February 2013 – Public defense

Insights into the effectiveness of internal audit: a multi-method and multi-perspective study

Rainer LENZ
Doctoral Thesis 01|2013

Université catholique de Louvain (UCL)
Louvain School of Management
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Doctoral committee

Internal members (UCL)
Prof. Philippe CHEVALIER
Prof. Yves DE RONGÉ
Prof. Gerrit SARENS (Supervisor)

External members
Prof. Kenneth D’SILVA
London South Bank University, UK
Prof. Kim K. JEPPESEN
Copenhagen Business School, Denmark
Prof. Florian HOOS
HEC Paris, France
MY PEAK PRODUCTIVITY

TOO MANY DISTRACTIONS

USUALLY AROUND 2:00am

TOO TIRED

WWW.PHDCOMICS.COM
Summary of my PhD dissertation

Why?

Risk based concept that helps the organization to achieve its objectives by positively influencing the quality of corporate governance.

How?

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Results / Key findings

- Many new research opportunities
Most studies are based on **self-assessments** of internal auditors.

The Little Prince

Drawing No. 1

Research gaps identified:

1. Include the stakeholder’s perspective on IA effectiveness;
2. Study factors that influence IA effectiveness and how IA effectiveness can be created and enhanced;
3. Provide definition of IA effectiveness.

Source: de Saint-Exupéry (1943), LE PETIT PRINCE
Relevance of the topic

• The subject of IA effectiveness is topical in practice but under-examined in academic research;
• The Institute of Internal Auditors (IIA) claims Internal Auditing (IA) to be a pillar of Corporate Governance*;
• The value of IA is questioned by some of its key stakeholders.

*) According to Huse (2007, 15), “Corporate governance is seen as the interactions between various internal and external actors and the board members in directing a firm for value creation.”
Motivation of research

1. Search for a path to effectiveness in IAFs

Since my appointment as a Head of Internal Audit (CAE) in the summer of 2007, I have searched for a path to effectiveness in internal audit functions (IAFs).

2. Role and expectations of SM matter

My first budget review as CAE in the autumn of 2007 clarified the importance of senior management’s (SM’s) expectations.

Make the Internal Audit Function (IAF) effective in practice.
The Little Prince

Drawing No. 1

Drawing No. 2

Source: de Saint-Exupéry (1943), LE PETIT PRINCE
What?
Auditing is a **credence good**
(Causholli, 2009)

- Audit customers cannot discern the quality of the good even after purchasing and consuming it;

- Audit quality is not directly observable except in the event of an audit failure;

- It is relatively easy to see in hindsight when an audit was not effective (Bender, 2006).
IA effectiveness, definition 1

Definition 1:

Risk based goal-attainment concept that helps the organization to achieve its objectives.
Risk based goal-attainment concept that helps the organization to achieve its objectives.

Positive influence on the quality of corporate governance (Sarens 2009).

Source: Sarens, Gerrit (2009), Internal Auditing Research: Where are we going?, IJA, Vol. 13 No. 1, pp. 1-7
IA effectiveness, definition 3

Definition 1:
Risk based goal-attainment concept that helps the organization to achieve its objectives.

Definition 2:
Positive influence on the quality of corporate governance (Sarens 2009).

Definition 3:
Risk based concept that helps the organization to achieve its objectives by positively influencing the quality of corporate governance.
How?
Structure of my doctoral thesis

- Literature review (Paper 1)
- Explorative study (Paper 2)
- Survey (Paper 4)
- IA profession (Paper 3)
- Interviews (Paper 5)
A multi-method and multi-perspective study

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Five related papers

1. In Search of a Measure of Effectiveness for Internal Audit Functions: An Institutional Perspective
   - Abacus, 2nd round

2. Factors Associated with the Internal Audit Function's Role in Corporate Governance

3. Reflections on the Internal Auditing Profession: What might have gone wrong?
   - Managerial Auditing Journal (2012), Vol. 27 No. 6, pp. 532-549

4. Testing the discriminatory power of factors of Internal Auditing Effectiveness: Sorting the wheat from the chaff
   - International Journal of Auditing, 2nd round

5. Internal Auditing Effectiveness: Multiple Case Study Research in Germany That Applies Role Theory and the Relational Theory of Coordination
   - Submission to Management Science in February 2013
Learn from differences

• As there is no typical (generic) Internal Audit Function or organization, my research seeks to study extreme cases in practice and learn from differences
  – Review both ends of the continuum
  – Comparatively strong and effective and poor and ineffective cases
Tintin and Snowy are very effective

Source: Hergé (1956): The Adventures of Tintin, The Black Island
An example of *in-effectiveness*

German Coast Guard
Results / key findings?
Internal Audit Effectiveness

Black box
Internal Audit Effectiveness

Black box

Insights

1. IA activities/processes
2. Organizational factors
3. Personal factors
4. Interpersonal factors

INSTITUTIONAL FORCES

Coercive
Normative
Normative
(2) Organizational factors

- IA is a service to the business
- The legitimacy of IA is context-dependent
- There can be organizational hypocrisy
- Organizational effectiveness influences IA effectiveness
  - Low organizational effectiveness may cap IA effectiveness
  - High organizational effectiveness may nurture IA effectiveness ("Hidden champions" are a rich source)

(4) Interpersonal factors

- There are "moments of truth" in an auditor's life
- Meeting expectations can be a misleading concept
- The CAE's interaction with SM can enhance or detract from IA effectiveness
  - Shared goals, shared knowledge, and mutual respect
  - Frequent, timely, and problem solving communication
- The "chicken and egg" problem of IA effectiveness
  - Successful interpersonal interaction can lead to IA effectiveness
  - IA effectiveness may also lead to improved interpersonal relations

(1) IA activities/processes

- "... evaluate and improve the effectiveness of risk management, control, and governance processes."
  - (Definition of IA, IPPF 2011, 2)
- Agent to the board/AC and partner to SM
  - View the board/AC as the chief stakeholder ("boss")
- Assurance and consulting services
  - View assurance as USP of IA
- Get the basics in place incl. IA charter and risk based IA
- Exploit technology to facilitate risk based IA
- Benefit from co-sourcing to complement skill set
- Aim to improve (QAIP) is positively associated with an IAF that has an active role in corporate governance

(3) Personal factors

- Metaphors "swimming in the organization" and "Fingerspitzengefühl"
  - Knowing what makes the company tick
- No fear or favor in controversial situations
  - Be able to call a spade a spade
- CAE agency (institutional entrepreneurship)
  - CAEs can improve the nature of interactions with key stakeholders and improve IA effectiveness
- IA qualification may help but its value may not be well known outside the IA area
Main contributions to academia

1) This dissertation uses the perspective of new institutional theory and entrepreneurship as a framework when providing a review of the existing empirical literature on IA effectiveness.

2) This dissertation offers an explanation why IA did not have a significant role in the financial crisis, neither as part of the problem nor as part of the solution.

3) This dissertation defines IA effectiveness as a ‘risk based concept that helps the organization to achieve its objectives by positively influencing the quality of corporate governance’.
Main contributions to academia

4) This research includes the first study that explores the variables that are associated with the IAF’s role in corporate governance.

5) This dissertation is one of only a few studies and the first one in the German context, in which CAEs and SM in the same organization are interviewed.

6) Micro level forces largely determine the type of IAFs that organizations have.

7) Supply of a fresh agenda for future research on IA effectiveness.
Main contributions to practitioners

1) This study suggests what CAEs should focus on in order to increase the effectiveness of their IAF, and/or to increase its role in corporate governance.

2) The CAE should clarify the customer dimension and the purpose and mandate of its IAF in the respective organizational context.

3) This study introduces metaphors to characterize the effective internal auditor: ‘Fingerspitzengefühl’ and ‘Swimming in the organization’ are metaphors, evocative of an effective internal auditor who represents an effective IAF.
Metaphor “Swimming in the organization”:

Associated with the more effective internal auditor, but that may not come risk-free

Source of image: ACL (2012), Don’t navigate risky waters without internal auditors: Guidance on leveraging audit analytics for risk assessment
Main contributions to the IIA

1) The dissertation shows the normative forces that demand compliance with the IA’s common body of knowledge to be comparatively weak at this time.

2) The study encourages the IIA to clarify its core remit and determine a chief stakeholder.

3) The IIA should review its curricula and consider ways to increase the relevance and practical usefulness of IIA degrees, especially for CAEs.
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Results / Key findings

Many new research opportunities
New research opportunities
Fresh agenda for IA research
40+ research questions

• What do we know about the causality of effective IA?
  – Successful interpersonal interaction between the CAE and SM (and the board/AC) can lead to (perceived) IA effectiveness;
  – In turn, rendering an IA service that is perceived as effective may also lead to improved interpersonal relations.

Experimental research is encouraged to learn more about causalities between factors that influence IA effectiveness.
Q&A
Appendices
What You Know vs. How much you know about it

![Diagram showing the relationship between what you know and how much you know about it. The x-axis represents 'How much you know about it' ranging from A Lot to Nothing, and the y-axis represents 'What You Know' ranging from Everything to Nothing. The graph shows a downward trend as education level increases from Undergrad to Master's to Ph.D., with an annotation saying 'Oops! You overshot it!' at the Ph.D. level.](www.phdcomics.com)
**Why?**
Clarify the enigmatic phenomenon of IA effectiveness. Provide suggestions for future academic research on IA effectiveness. *)

**What?**
Literature review ("supply- and demand-side") through an "effectiveness lens".

**How?**
Institutional theory and institutional entrepreneurship (DiMaggio and Powell, 1983; DiMaggio, 1988) as framework.

**Results/key findings:**
Institutional forces affect IA effectiveness but cannot fully explain the plurality in practice. Organizational hypocrisy and agency are two theoretical outcomes when isomorphic forces point in different directions and/or are in conflict with organizational demands.

**Implication/key contribution:**
CAE agency is suggested as a new field for empirical research. The CAE who typically seeks to meet others’ expectations may become an agent who drives change.

*) Q1: What characterizes the comparatively more effective, and value-adding, IAF?
Why?
Many IAFs do not play an active role in corporate governance. Provide guidance to strengthening the role of IAF’s in corporate governance.

What?
Investigate variables that are associated with IAF’s role in corporate governance.

How?

Results/key findings:
IAF having an active role in corporate governance is significantly and positively associated with the use of a risk-based audit plan, existence of a quality assurance and improvement program, and audit committee input to the audit plan.

Implication/key contribution:
For CAEs who wish to increase their IAF’s role in corporate governance. The effectiveness of an IAF depends on its interactions with other corporate governance stakeholders.
Why?
Investigate why the IA profession has been marginalized in the governance debate on solutions after the financial crisis that started in 2007.

What?
Conceptual discussion that offers an explanation for the IA profession’s marginalization.

How?
Based on an objective review of relevant literature, both practitioner and academic.

Results/key findings:
Serve the chief stakeholder best and first (it is suggested that to be ideally the board/audit committee), and narrow but deepen the value proposition in the arena of assurance service at the expense of consulting services is the suggested path forward.

Implication/key contribution:
For practitioner: Clarify the ultimate customer and the core IA service.
For IIA: May help when seeking universal recognition for IA as a profession.
Paper 4

Why?
Identify differentiating characteristics of IAFs considering organizational factors, IA resources, IA processes, and the pattern of relationships between the CAE and key governance stakeholders.

What?
Rough tool for pointing to levels of IA effectiveness at both ends of the range.

How?
Empirical survey based on 46 CAEs in private organizations in Germany.

Results/key findings:
We find IAF characteristics that differentiate between IAFs that could be seen as determinants (“seeds for a theory”) of IA effectiveness: IA charter, possible career progression after a tenure in IA, some degree of co-sourcing, the level of training and professional qualification of IA staff and CAEs, the use of IA technology and risk-based IA, whether IA rates individual findings and grades the overall report, whether the CAE has appropriate access to the board/AC and senior management’s (SM).

Implication/key contribution:
Micro-level: Get the basics in place; Rate individual findings and/or grade the overall IA report; Benefit from co-sourced services to complement the IAF’s skill; Aim to improve through qualification and continuous learning; Exploit technology; Right level of informal communication with SM; Improve (and benefit from) the level of access to the board/AC.

Macro-level: Upgrade the value of IA designations for CAEs; Strengthen quality assurance and improvement programs; Emphasize the link between the CAE and the oversight body.
Why?
Improve the understanding of IA effectiveness by studying the relationship between the CAE and SM working in the same organization.

What?
Multiple-case-study that introduces and hardens new theories.

How?
16 semi-structured interviews of CAEs and SM in private organizations in Germany.

Results/key findings:
Role theory (Kahn et al. 1964) when combined with the theory of relational coordination (Gittell 2006) provides a promising theoretical framework that is well tailored to the research subject of IA effectiveness.

Implication/key contribution:
Organizational factors: “Hidden champions” demand and benefit from effective IA practices.
Personality factors: “Swimming in the organization” and “Fingerspitzengefühl” are suggested metaphors for effective internal auditors.
Interpersonal factors: Frequent, timely and problem-solving communication nurture IA effectiveness especially when such communication is supported by shared goals, shared knowledge, and mutual respect.