THE FUTURE OF CORPORATE GOVERNANCE: INSIGHTS FROM THE NETHERLANDS

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FOREWORD

A research report resulting from collaboration between two accounting bodies from different countries is unusual. Although this report is published by the Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) it reports a study carried out jointly with the Koninklijk Nederlands Instituut van Registeraccountants (NIVRA). It may help to explain why we all thought this was worth doing.

One of the most striking characteristics of the political outlook today in the western world is the shared view that the success (or otherwise) of any government is inextricably linked with the success of the economy for which they have responsibility. Coupled with that realisation is a growing recognition that companies are the engine of a successful economy. As a result there is now wide consensus that the main role of government is not to act as a business itself but instead to create an environment in which enterprise can flourish, whilst addressing the more serious social imbalances that a market economy can create.

If companies are to be the engine of an economy, it matters greatly that they are well run. This is one of the important drivers behind the rapid and recent acceptance internationally of the importance of good corporate governance. The other stems from the internationalisation of capital markets and the rapid and dramatic growth in them, and the resulting need to ensure that the lowest common denominator in terms of accepted practice is of an acceptable level with strong encouragement for, and disclosure of, best practice.

It has much longer been recognised, however, that without accurate and timely information, capital markets cannot work properly. For so long as a typical country managed its own capital market, usually reflecting its own pattern of business practice, there was no imperative for any consensus as to international best practice to develop. Nevertheless, the high international standing of both NIVRA and ICAS is a reflection of the way their members have helped to meet the need for such information, for more than a century, both within their own country but also in extant international markets.
The approach of each body reflects different traditions and insights into how assurance as to the reliability of reported accounting such information can best be provided. Each tradition also reflects differing approaches to the challenging task of monitoring the financial control that is needed within a business. With the rapid internationalisation of capital markets much has changed, and a shared study such as this can be much more useful than one reflecting the thoughts of those familiar with just one approach.

The study itself was stimulated by some bold recommendations contained in an ICAS discussion document *Auditing into the Twenty-first Century*, published in 1993. By choosing the recommendations of that study which related to practices similar to those already in place in the Netherlands, and linking with NIVRA in carrying out this research we hope the resulting research report will be, of real assistance to those considering the future of corporate governance and evaluating the role that can be played by internal auditors in it.

Nigel Macdonald
Convener
Research Committee

May 2000
Preface

Introduction

The topic of corporate governance and the issues raised in this research report are of interest worldwide. In particular, in the US issues of corporate governance including auditor performance continue to be highly visible. In view of this I was invited to write the preface for this report and provide a commentary from a US perspective. Since Auditing into the Twenty-First Century (ICAS, 1993) was published, numerous events have demonstrated an ongoing need for excellent corporate governance and superior corporate reporting accomplished through greater management focus and enhanced control structures, improved audit quality and more effective oversight by audit committees. The corporate governance and auditing proposals suggested by this research offer solutions which could be constructive.

Recent US developments

A review for Congress of the accountancy profession in 1996 by the US General Accounting Office acknowledged progress in achieving auditor independence but noted that concerns remained and concluded that an expectation gap still existed for detecting fraud and determining the effectiveness of internal controls.1 Additional focus on the problem of fraudulent financial statements was provided by a study funded by the Committee of Sponsoring Organizations of the Treadway Commission released in March 1999. This research reports that over ten years, cases of demonstrable financial statement fraud have averaged 30 per year. The research noted several cases of external auditor misdeeds. Recurring examples of restatement of previously issued financial statements have also cast doubts on auditor effectiveness.
In May 1993, the American Institute of Certified Public Accountants (AICPA) sponsored an Audit/Assurance conference. It was based on the premise that demand for audits and other attest services had declined and users of the services had expressed dissatisfaction with their scope and utility. The major outcome of the conference was establishment of an AICPA Special Committee on Assurance Services. A key strategy was that 'the assurance function should place a renewed emphasis on meeting users' needs'. As a consequence of these activities, the term 'audit' has virtually disappeared from the lexicon and organisation of the large firms. Supported by extensive marketing, the firms have attempted to differentiate and thereby commoditise the auditing services they market to clients. The result has been a bundling of internal and external auditing into one engagement offered under the banner of 'Assurance and Business Advisory Services'. The objective of better meeting users' needs seems to have been largely operationalised through providing services of greater value to the client who pays the bill. This strategy has undoubtedly resulted in diminished attention to the interests of investors and the general public.

Because of dissatisfaction with the existing auditor independence rules and their enforcement by the AICPA, in 1997 the Securities and Exchange Commission (SEC) joined with the AICPA to sponsor a new private sector oversight body called the Independence Standards Board. The SEC subsequently transferred to this board its direct responsibility for setting standards for and enforcing the independence of external auditors. One of the major issues leading to the board's formation was the potential for conflicts of interest resulting from the practice described above of Certified Public Accountant (CPA) firms performing ever-larger amounts of business advisory and non-audit services for their audit clients. In mid-1998 the board began a monumental effort to develop a conceptual framework for auditor independence.

In August 1998, the SEC called a series of meetings with financial executives, investment analysts, and the Big Five. Their purpose was to determine the cause of a spate of 'corporate accounting fiascos at publicly traded companies'. The list contains some very large companies and the
culpability of audit committees has been questioned in several of these cases. Also, institutional investors have marked improvement in such panels as the next big push in reform of corporate governance.\textsuperscript{3}

To put further emphasis on the need for reform, SEC Chairman Arthur Levitt on 28 September 1998 scolded America’s public companies and their independent accountants for using ‘accounting hocus-pocus’, and announced a nine-point initiative.\textsuperscript{4} The SEC has subsequently issued several pronouncement clarifying previous accounting and auditing concepts. Levitt also convened a Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. This committee has recommended increased auditor contact with audit committees and higher standards for audit committee membership and more extensive deliberations.\textsuperscript{5} The majority of these recommendations are in various stages of implementation. A report on audit effectiveness by the Public Oversight Board\textsuperscript{6} is pending release.

The National Association of Corporate Directors has sponsored another effort to improve audit committee effectiveness. It convened a Blue Ribbon Commission on Audit Committees in 1999 to prepare practical guidance on audit committee duties and how to carry them out effectively.\textsuperscript{7} The purpose of this is to assist directors to clear the ever-rising bar of performance being expected of them.

**Major differences in the audit environment**

There are major differences in the auditing environment between the US and other countries that each affect the feasibility of the proposals to provide answers to the challenges facing auditing in the US. These considerations involve statutory, professional, and societal aspects.

1 **Federal regulation of external auditing**

The SEC is charged with administering securities acts originally passed in 1933 and 1934 but amended frequently since. Included in the SEC's mission is the power to set rules involving both public company accounting and auditing. Although maintaining oversight responsibility,
it has delegated most of the work to the private sector. Accounting principles are set primarily by the independent Financial Accounting Standards Board (FASB). Auditing standards are determined by the Auditing Standards Board of the AICPA. Over the years, the SEC has enforced its rules by requiring companies to revise financial reports, by suspending trading in selected securities when appropriate information was not forthcoming and by censuring or disqualifying CPAs from practice for misdeeds. Adoption of the research proposals would require careful study by the SEC so it would not be hindered from performing its legislative mandate of shareholder protection.

2 State licensing of CPAs

State Boards of Accountancy set residence, experience and education requirements for obtaining a license to practice public accountancy as defined in state law. Administration of Uniform CPA Examinations created by the AICPA is also accomplished by the states. Violations of ethics rules are adjudicated jointly by the states and the AICPA. The National Association of State Boards of Accountancy would wish its views to be included in discussions of any new system for regulating the practice of public accounting.

3 CPA profession self-governance

As a response to SEC criticism of alleged sub-standard auditing by the large firms in the 1970s and related critiques by Congress, the AICPA organised a Division of Firms and SEC Practice Section (SECPs) designed to perform peer reviews of auditing performance. Because of the legislative mandate for an annual audit of all public companies, the SEC has maintained general oversight of the process, but delegated administration of the SECPs to a Public Oversight Board (POB) composed of non-CPA practitioners. The POB also monitors alleged audit failures coming to public attention and publishes monographs based on its own research. The most pertinent to the subject matter of this research is: Strengthening
the Professionalism of the Independent Auditor. Among other recommendations, this work states that 'the auditor must look to the board of directors as the client'.

4 Relevant corporate governance principles

Corporations in the US are legally chartered under the laws of an individual state, not the federal government. Only one state requires corporations it charters to appoint a standing audit committee. Yet, the New York and American Stock Exchanges and NASDAQ either require or recommend their listed corporations maintain audit committees. In response, virtually all publicly held corporations do have standing audit committees of the board. New York Stock Exchange rules currently require each member to be an outside non-executive director. Additional requirements are in process of implementation as a result of the SEC initiatives described earlier.

How effectively audit committees discharge their responsibilities is a different question. No states have yet enacted into law the recommendations contained in Principles of Corporate Governance published by the American Law Institute (ALI) although they are frequently cited in court decisions. The ALI is an organisation of law school deans and professors, judges, and prominent practising attorneys. The Principles include a recommendation for legally requiring an audit committee in large public corporations and also prescribing its functions. The only current statutory requirements relating to audit committees are contained in the FDIC Improvement Act of 1991. This law affects large depository institutions with more than $500 million in assets. The regulations implementing this law spell out specific characteristics that audit committee members must have and state their duties in some detail.

The duties of directors of a public corporation related to oversight of matters relating to auditing were significantly increased by the 1996 in re Caremark, International, Inc. decision of the Delaware Chancery Court.
Directors must henceforth 'assure that appropriate information and reporting systems are established by management' so that 'appropriate information will come to its [the board's] attention in a timely manner'. This decision has implications for audit committees and internal auditors who are likely to be involved in assuring the quality of information flow to the board as a whole. Interestingly, Judge William Allen, who wrote the Caremark opinion as Chief Justice, is now the chair of the Independence Standards Board.

5 Societal litigiousness

The United States is well known as a litigious society, having more attorneys per thousand population than any other industrialised country. Users of the civil system of jurisprudence find it incredibly costly. The considerable number of lawsuits against auditing firms has served as an important influence on how public accounting is practised. The former Big Six accounting firms reported that in 1993, approximately 11 percent of their revenue was used to pay for present, past and future legal settlements. Because of the concept of joint and several liability, auditors have been considered 'deep pockets' that resulted in their making payments far out of proportion to their responsibility for loss. The courts may also hold auditors to a higher standard of performance than that contained in a narrow reading of auditing standards. This factor has also been a cause of the US 'expectation gap'.

Because of these issues, the CPA profession lobbied Congress to reduce their risk of liability under the securities laws. This effort was successful in 1995 with the passage of the Private Securities Litigation Reform Act over President Clinton's veto. This law eliminates joint and several liability and sets forth much more stringent conditions which must be met before accountants can be held liable for their negligence. The long-term import of this legislation for the auditing profession has yet to be fully evaluated.
Comments on the proposals

The proposals can be viewed as being in two categories. The first involves recommendations that are reasonably consistent with existing institutional structures in the US. They are Proposals 1, 2, and 3. These deal with establishing, managing, and maintaining an internal audit function having superior competency, highly regarded stature, wide-ranging responsibilities, and a mandate to report to the highest organisational level. Internal auditing has been undergoing considerable re-evaluation and self study. Its potential to provide valuable services has never been greater. Hopefully, internal auditors will rise to the challenges they face and make effective contributions to corporate governance. These proposals should be carefully considered by thought leaders in corporate governance in the US as well as those in the internal auditing profession.

A new definition of internal auditing recently adopted by The Institute of Internal Auditors, Inc. contains specific language concerning internal audit involvement with corporate governance. However, the new definition also covers internal auditor performance of activities involving operational auditing, consulting activities and other value-added services. A current research study sponsored by The Institute of Internal Auditors Research Foundation is designed to study the role of internal auditing in corporate governance in the past and suggest an appropriate mission for the future.

The pressure of global competition has resulted in limitations on the scope of internal audit functions in many corporations. Activities that demonstrably add value in the short run may take precedence over routine verification of financial transactions. On the other hand, there is a growing ground swell of recognition that a broader focus on assessment of a wide spectrum of business risks has considerable value to management and the board. Such risks include technological systems risks, integrity risks, and operational risks as well as those of misstated financial information.

In the US, audit committees as well as the board as a whole receive great organisational flexibility from corporate jurisprudence and thus exercise wide latitude in tailoring their responsibilities as well as how
they discharge them to the specific circumstances of their company. As a consequence, internal audit functions are likely to vary considerably among companies and industries in their mission, scope, and resource availability. A doctrinaire one-size-fits-all mandate is not likely to be widely embraced.

Enactment of Proposals 4, 5, and 6 in the second category, however, would require major modification of the generally accepted auditing standards that are promulgated by the AICPA as well as potential changes in the legal structure of corporations and regulatory philosophy of the SEC. Thus, their quick adoption in the US would seem to be much less likely. However, they do address issues of external auditor independence, an area of great current concern. Therefore, their merits should be carefully considered.

In summary, all of these proposals have considerable intrinsic merit and should be presented for evaluation by the corporate governance community and internal auditing profession and considered for adoption by all public companies in the US. This is particularly true in view of the revolution underway to rapidly accelerate the dissemination of current and projected corporate financial information using the internet and other means. Stereotypical audited historical financial statements issued well after the fact are undoubtedly becoming less and less relevant to decision makers.

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Endnotes:


5 Ira Millstein and John C Whitehead, Report and Recommendations of the Blue Ribbon Committee on Improving Audit Committee Effectiveness, New York: New York Stock Exchange and National Association of Securities Dealers, 1999

6 Request for Opinions on Issues of Audit Effectiveness - Addressed to Thought Leaders and Key Stakeholders, Panel on Audit Effectiveness appointed by the Public Oversight Board of the SEC Practice Section of the AICPA, September 1999


8 Advisory Panel on Auditor Independence, Strengthening the Professionalism of the Independent Auditor, Stamford, CT: Public Oversight Board, 1994


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For their work on the Dutch literature a special mention must be made of: Arnold van Amsterdam, (Senior Lecturer in Auditing, University of Amsterdam); Jerry Hamel, (Department Director of Group Audit, ABN AMRO Bank); Pieter Oostlender (Financial Controller, Sylvan Prometric); and Lucette Plug and Nathalie Snel, (KPMG, Accountants, Amsterdam). Unfortunately Lucette never saw the final result of her work as she died before the research report was published.

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The Research Committee and the researchers are particularly grateful to the Trustees of the Scottish Chartered Accountants Trust for Education who gave financial support for this project.
EXECUTIVE SUMMARY

In view of the high profile of corporate governance issues in today's business environment, and the extensive debate that *Auditing into the Twenty-first Century* (ICAS, 1993) has attracted since its publication, it was thought to be desirable to revisit its proposals in the context of the current business and regulatory climate.

This report presents the results of the first stage of an investigation into the future of the external audit function and corporate governance more generally. The research is centred on the proposals contained in *Auditing into the Twenty-first Century* (ICAS, 1993) and, because of the close parallels with Dutch practice, was set up as a collaborative venture between ICAS and NIVRA in the Netherlands.

This report provides a review of the relevant Anglo-American and Dutch literature on internal monitoring bodies and presents the views of thirteen key individuals in three major Dutch companies. It makes recommendations regarding how the proposals in *Auditing into the Twenty-first Century* might be either confirmed or amended in the light of insights obtained from the Dutch fieldwork and of developments since 1993 in the areas of financial reporting, auditing and corporate governance.

**Objectives and research approach**

The three specific objectives of the research reported here are:

- To review the relevant Anglo-American and Dutch literature with a view to identifying issues for investigation in the subsequent fieldwork stages of the project.
To identify and understand present corporate governance practice in the Netherlands with particular reference to the audit function. For each of the companies visited this involves:

- identification of the functions, responsibilities and modus operandi of the audit committee, internal audit function and supervisory board;
- assessment of how these bodies interact with each other and with the executive board and external auditors; and
- identification of how the bodies' effectiveness is measured and whether they are perceived to be effective.

To either confirm the desirability and feasibility of the original ICAS proposals or to recommend amendment.

Literature review

In carrying out the literature review, the researchers explored academic and professional literature relevant to the proposals contained in Auditing into the Twenty-first Century, in respect of internal monitoring bodies and their relationships with the external audit function. The researchers concentrated particularly on literature published within the last fifteen years and covered literature other than that emanating from the UK or the Netherlands where this was appropriate. This additional literature is largely US and to a lesser extent Canadian or Australasian. The following internal monitoring bodies were examined: audit committee; internal audit; and supervisory board. The key topics addressed for each were: history and development; functions and responsibilities; composition/staffing; assessment of effectiveness; and interaction with other internal and external parties.
Dutch fieldwork

Three major Dutch companies agreed to participate in the project and interviews were conducted with a variety of officials in each company. The interviews were designed to explore the ways in which audit aspects of the Dutch corporate governance system operate within the companies interviewed. The Dutch fieldwork aimed to identify the functions and responsibilities of internal audit, supervisory boards and audit committees; establish the interfaces between monitoring bodies and board of management; and establish how the effectiveness of internal and external monitoring bodies is measured and assessed.

Main findings: strengths and weaknesses of Dutch system

The following main strengths and weaknesses of the Dutch system (not all of which are unique to this system) were identified from the fieldwork:

Strengths

- The existence of a group of independent specialists within the company (supervisory board) offered the possibility of a group within the company with an interest in preserving the independence and effectiveness of the internal and external auditors.
- The internal audit function within the companies was strong in terms of its size and the professional quality of its staff. Heavy reliance on internal audit by the parent management board in the companies was also apparent.
- The extension of internal audit work to cover operational control matters and risk assessment indicates the evolution of internal audit from its traditional financial statement assertion focus to the status of adviser to top management on all aspects of the business.
- The quality of Dutch internal audit within the companies was recognised by the external auditors, who co-operated extensively with them in the planning, execution and review of the audit effort.
Weaknesses

- In the companies visited it was noted that there was a commonality of personnel on the supervisory board and audit committee. In the case of two companies the audit committee was a sub-committee of the supervisory board, while it comprised the full supervisory board in the other company.
- It was suggested that there was a lack of independence of the supervisory board from the management board. This was mainly because of the lack of involvement in the day-to-day running of the company, the lack of time available and the fact that information was presented with the conclusions already drawn.
- The commonality of personnel on the supervisory board and audit committee could lead to a lack of financial reporting and auditing expertise on the audit committee. This could limit the Committee's effectiveness in the supervision of the audit process.
- It was possible that there was a lack of independence of internal audit from the parent board.
- The supervisory boards' primary role was to supervise the board of management. Although the supervisory board had an interest in confirming that internal audit was effective and rigorous this was a secondary consideration. This may lead to the lack of a positive approach to supporting and monitoring internal audit.

Modified proposals

Developments in the business and regulatory environment since 1993, together with the insights gained from the literature review and the Dutch fieldwork, suggest various amendments to the ICAS (1993) proposals. These modified proposals are presented in the form of six proposals, four of which argue for the retention of the original ICAS proposals and two of which suggest that the role of key internal monitoring bodies be extended.
Executive Summary

Retained proposal 1: Each company should appoint a strong internal audit team that is capable of providing the Financial Reporting and Audit Committee (FRAC) with sufficient information to fulfil its responsibilities on behalf of the board.

This proposal parallels a strength found in the Dutch system, which is the existence of a strong internal audit function.

Retained proposal 2: The findings of each investigation by the internal audit function should be reported to the chief executive, the FRAC and the external assessors.

This proposal overcomes two weaknesses identified in the Dutch system – the lack of independence of internal audit from the parent board and the lack of a positive approach to supporting and monitoring internal audit.

Extended proposal 3: The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and internal control systems and on the conformity of financial statements with the accounting records and legal and accounting standard requirements should be extended to cover: the identification of significant business risks; the effectiveness of financial, operational and compliance controls; the quality of management information and the effectiveness of management.

This proposal parallels a strength of the Dutch system, which is the extended nature of audit work performed by internal audit.

Retained proposal 4: The external auditors should be renamed the external assessors and that to a considerable extent the work of the external assessors would carry out their work by assessing the work of a company's internal auditors.

This proposal parallels a strength of the Dutch system, which is the close co-operation between internal and external audit. It is also consistent with the move, worldwide, to strategic systems-based auditing.
Retained proposal 5: An independent Audit Review Panel (ARP) should be established to take responsibility for the supervision of the assessment process on behalf of the primary stakeholders, while being responsive to the needs of the secondary and tertiary stakeholders.

This proposal introduces a strength of the Dutch system, which is the existence of a group of independent specialists within the company. It also addresses two weaknesses. First, it removes the commonality of personnel involved in monitoring bodies. Second, it might be expected to mitigate, at least partially, the lack of expertise among audit committee members.

Extended proposal 6(a): The role of the ARP proposed by ICAS (1993) should be broadened to a more proactive supervision of the planning, execution, completion and reporting of audit work undertaken by the external assessors. This would help to ensure that due rigour is applied to the assessment process.

New proposal 6(b): The ARP should adopt a watching brief over the internal audit function, to confirm its effectiveness and independence within the organisation.

Proposal 6(b) addresses two weaknesses of the Dutch system – the lack of independence of the supervisory board from the management board and the lack of a positive approach to supporting and monitoring internal audit.

Stage two of the project

An assessment of the feasibility of implementing these modified proposals will form the basis for a series of interviews to be undertaken in UK companies, which constitutes the second stage of the project.
CHAPTER ONE

INTRODUCTION

This report presents the results of the first stage of an investigation into the future of the external audit function and corporate governance more generally. The research is centred on the proposals contained in *Auditing into the Twenty-first Century* (ICAS, 1993), a discussion document published in June 1993 by the Research Committee of The Institute of Chartered Accountants of Scotland (ICAS). *Auditing into the Twenty-first Century* was the result of a major investigation into how the expectations gap in auditing might be reduced in an effective manner. The document proposed major revisions to the functions and responsibilities of external auditors and to the structures of corporate governance. Given the high profile of corporate governance issues in today’s business environment, and the extensive debate that *Auditing into the Twenty-first Century* has attracted in the years since its publication, it was thought to be desirable to revisit its proposals in the context of the current business and regulatory climate.

This project is a collaborative venture between ICAS and the equivalent professional body in the Netherlands, Koninklijk Nederlands Instituut van Registeraccountants (Royal NvRA). The Netherlands was selected for study because of a close parallel between Dutch practice and aspects of the proposals contained in *Auditing into the Twenty-first Century*. The project has two distinct stages. This research report presents the results of the first stage which consists primarily of a review of the relevant Anglo-American and Dutch literature and a series of thirteen interviews with key individuals in three major Dutch companies. Each of these is a profitable and growing company listed on the Amsterdam Stock Exchange.

This report makes suggestions as to how the proposals made by *Auditing into the Twenty-first Century* might be confirmed or amended in the light both of insights obtained from the Dutch fieldwork and of
more recent developments in corporate governance and financial reporting in the UK and worldwide. An assessment of the feasibility of implementing these modified proposals will form the basis for the series of interviews to be carried out in major UK companies, which constitutes the second stage of the project. A future research report will present our findings from this stage of the research, together with final conclusions and recommendations.

**Background to the project**

*Auditing into the Twenty-first Century* contained a number of radical proposals for the reform of the present UK corporate governance structure for listed companies. One such proposal was that:

*To provide a board of directors with reassurances that its management information systems and internal control systems are sufficiently reliable and relevant, we believe that each company should establish and maintain a strong internal audit function* (ICAS, 1993 p32).

There was, however, no UK evidence to substantiate whether this proposal would be workable. During the course of its work on *Auditing into the Twenty-first Century*, the Research Committee had become aware of the experience of a number of major companies in the Netherlands using internal audit to undertake many of the external audit functions and, in particular, the internal certification of financial statements. In view of this parallel between Dutch experience and a key proposal of *Auditing into the Twenty-first Century*, the Research Committee commissioned a project with the general aim of investigating the experiences of corporate governance, with particular reference to the audit function, in the Netherlands and assessing them in the UK context.

The research therefore seeks to establish, through research in the Netherlands and the UK, the inter-relationships between internal monitoring bodies, in particular, the information needs of, and information flows between, these bodies. For the purposes of this project, internal monitoring bodies are defined as those structures established within organisations for the purposes of securing effective corporate governance.
generally and for financial reporting and control in particular. The functions of these internal monitoring bodies are exercised through ensuring accurate data is supplied to executive directors and by monitoring their conduct effectively. For the purposes of this report, internal monitoring bodies comprise, therefore, internal audit departments, audit committees and, in the Netherlands, supervisory boards. Supervisory boards, which in certain cases may exercise an audit committee role, are particularly important given that the corporate governance arrangements in the Netherlands are a major theme of this project.

Objectives

The three specific objectives of this stage of the research project are:

- To review the relevant Anglo-American and Dutch literature with a view to identifying issues for investigation in the subsequent fieldwork stages of the project.

- To identify and understand present corporate governance practice in the Netherlands with particular reference to the audit function. For each of the companies visited this involves:

  - identification of the functions, responsibilities and modus operandi of the audit committee, internal audit function and supervisory board;
  - assessment of how these bodies interact with each other and with the executive board and external auditors; and
  - identification of how the bodies' effectiveness is measured and whether they are perceived to be effective.

- To either confirm the desirability and feasibility of the original ICAS proposals or to recommend amendment.
Recent developments in corporate governance and financial reporting

The research reported here has been carried out in the context of significant public concern over the past decade as to the efficacy both of external audit and of corporate governance more generally. This concern has resulted in several major reports on corporate governance, The Cadbury Report (Cadbury, 1992), The Greenbury Report (Greenbury, 1995), The Hampel Report (Hampel, 1998) and, most recently, Internal Control: Guidance for Directors of Listed Companies Incorporated in the United Kingdom (The Turnbull Report) (ICAEW, 1999). There has also been a series of discussion documents from the APB, in particular, The Audit Agenda (APB, 1994) and The Audit Research Agenda (1996). This literature raises issues regarding some of the monitoring bodies considered in this research; in particular, audit committees and internal audit. The content of these documents is considered in more detail in chapter two of this report.

The research takes place within the context of increasing speculation by a number of bodies and individuals around the world on the future shape of financial reporting. This, in turn, creates an additional area for research; the form of the assurance services which will be required to report on any new forms of financial reporting. The future form of financial reporting is the subject of another ICAS Research Committee report, Business Reporting: The Inevitable Change? (ICAS, 1999). This report proposes changes, inter alia, to both the scope and the timeliness of business reporting. Were these proposals to be implemented, changes would probably be required to the skills base of the auditors who would provide assurance on the new forms of business reporting. This has an obvious relevance to the subject matter of the research reported here and, in particular, the roles of external and internal auditors.

Innovative aspects and benefits of the research project

This research project is unusual and innovative in that it is the result of international cooperation between two professional bodies of accountants from different countries. Instances of professional
international collaboration in a research project of this nature are very rare. The research work for the project has been carried out by Scottish and Dutch teams of researchers working in collaboration (based at Glasgow Caledonian University, Scotland and at the University of Amsterdam the Netherlands, respectively). These international aspects of the project bring into focus two distinct cultures and traditions of accounting, auditing and corporate governance and facilitate the comparative evaluation of these.

The Dutch input to the research made the identification of important cultural differences between the two countries easier and the involvement of NIVRA facilitated the identification of appropriate companies for interview as well as the arrangement of interviews with key individuals involved with corporate governance within the selected companies. Dutch participation in the interviews helped to avoid the misunderstanding and confusion about Dutch corporate culture which might otherwise have arisen.

**Approach to literature review**

In carrying out the literature review, the researchers explored academic and professional literature relevant to the proposals contained in *Auditing into the Twenty-first Century*, in respect of internal monitoring bodies and their relationships with the external audit function. The researchers concentrated particularly on literature published within the last fifteen years and covered literature other than that emanating from the UK or the Netherlands where this was appropriate. This additional literature is largely US and to a lesser extent Canadian or Australasian. The UK researchers concentrated primarily on material from the UK and the US1 and identified the following internal monitoring bodies to be relevant: audit committee; internal audit; and the Audit Review Panel (ARP) as proposed by ICAS (1993). The Dutch researchers concentrated on Dutch literature and identified the following internal monitoring bodies to be relevant: supervisory board; audit committee; and internal audit.
Audit committees and internal audit have particular relevance to *Auditing into the Twenty-first Century* as these are the existing monitoring bodies with which the ICAS proposals are principally concerned. The supervisory board is not directly relevant to the ICAS proposals but is a prominent component of the Dutch corporate governance model and so is included here.

In considering each of these internal monitoring bodies, the following key topics were addressed:

- history and development;
- functions and responsibilities;
- composition/staffing;
- assessment of effectiveness; and
- interaction with other internal and external parties.

Other topics were covered as appropriate.

**Contents of the report**

The remainder of this report proceeds as follows. Chapter two sets the scene for the research. It explains the proposals of *Auditing into the Twenty-first Century* in some detail. It also discusses recent developments in corporate governance as well as differences between the Dutch and UK corporate governance cultures.

Chapters three to six report on the detailed literature review. Separate chapters deal with audit committees, internal audit and supervisory boards, while chapter six addresses the interfaces between these internal monitoring bodies and external audit. Because, the *Auditing into the Twenty-first Century* proposals entail close cooperation between audit committees, and external and internal auditors, it was thought worthwhile to specifically examine literature on the interfaces between these three bodies. Each chapter concludes with an analysis and comment section, which synthesises the principal points of interest, and identifies key issues for investigation.
at the fieldwork stage of the project. Chapter seven provides a link between the literature review and the fieldwork. It summarises the literature review and describes the approach taken to the Dutch fieldwork.

Chapters eight to ten report on the Dutch fieldwork. This is organised into three areas. Chapter eight covers functions and responsibilities. The quality of the relationships between various bodies, e.g., internal audit, FRAC and ARP, is fundamental to the proposals made by ICAS (1993). Chapter nine, therefore, examines the various relationships between the different monitoring bodies which operate within the context of corporate governance in the Netherlands. The chapter explores how these relationships were perceived to work by interview participants and discusses the implications for the overall effectiveness of audit.

The concept of effectiveness, however, needs to be discussed not only for audit generally but also for all corporate governance bodies that have audit implications. Chapter ten, therefore, investigates the effectiveness of each internal monitoring body. The more general corporate governance bodies such as the supervisory board are included since their effectiveness impacts on the effectiveness of those functions which are more specifically orientated to audit.

Chapter eleven provides an overall analysis of the strengths and weaknesses of the Dutch system and develops the ‘modified ICAS (1993) proposals’. Chapters two, seven and eleven together provide an overview of the project.

Endnote:

1 The US is not a principal focus of this project. In addition, it should be noted that the US system of corporate governance may be distinguished in several respects from that which exists in the UK. Nevertheless, much of the literature on audit committees and internal audit originates in the US and relates to either system. It has, therefore, been drawn upon where appropriate, although no attempt at comprehensive coverage of the US literature per se has been made.
CHAPTER TWO

SETTING THE SCENE

This chapter provides some necessary background. It begins by outlining the nature of corporate governance and summarising the proposals made in *Auditing into the Twenty-first Century*. The principal differences in the corporate governance systems and cultures of the Netherlands and the UK are then discussed. Finally, recent matters of concern in the corporate governance area are discussed.

The nature of corporate governance

Corporate governance has been defined by the Cadbury Committee as ‘the system by which companies are directed and controlled’ (Cadbury, 1992). Although, this definition was accepted by the subsequent Hampel Committee (Hampel, 1998), it nevertheless made the point that this definition is a restrictive one since it ‘excludes many activities involved in managing a company which may nevertheless be vital to the success of the business’ (Hampel, 1998). It is worth noting that the Hampel Committee appeared, on the basis of this extract, to equate corporate governance with management. At best this seems simplistic and, at worst, erroneous. Tricker (1984) distinguished corporate governance from management by observing that, if management is about running the company, corporate governance is about ensuring that the company is run properly.

The Cadbury Committee definition locates directors and shareholders at the centre of corporate governance. Arguably, this definition does not give sufficient recognition to other stakeholder groups who have a legitimate interest in the organisation. While the Hampel Committee recognised stakeholders other than shareholders, it appeared
to have a restricted view of the extent of their interest. Hampel, therefore, made the point that the directors’ duty is to shareholders (our emphasis) both present and future and argues for the development and sustaining of other stakeholder relationships on the grounds that this will facilitate the objective of long term shareholder value. More radical conceptions of corporate governance are, however, possible, viz the pluralist approach outlined in the company law review consultation (DTI, 1999). According to Humphrey and Owen (1999), ‘the real issue we face is one of establishing new forms of institutional governance within which the voices of all stakeholders may be heard, and organisations can thereby be truly conceived of as social institutions’.

Auditing into the Twenty-first Century proposals

This section reviews the proposals contained in Auditing into the Twenty-first Century (ICAS, 1993) that are relevant to this project. A major driver of the ICAS (1993) proposals was the belief that, in the future, boards of directors will be required to provide more reassurances to the public than they do under the existing framework of corporate governance. Of particular relevance to this research is the proposal that, in the case of listed companies, each board of directors should report:

whether it has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to provide the board with (i) the information necessary for the preparation of financial statements which give a true and fair view, and with (ii) reassurances that, inter alia, the opportunities for fraud and other illegal acts are minimised … (ICAS, 1993, pp31-32).

Three specific proposals made by ICAS (1993) on the system of corporate governance as it relates to audit follow from this proposition:
• **Enhanced internal audit function.** It was proposed that each company should establish and maintain an internal audit function which would be significantly stronger than that typically found in UK listed companies. This enhanced internal audit function would be responsible for much of the detailed audit work which, under the existing arrangements for audit, are carried out by the external auditors.

• **Establishment of a Financial Reporting and Audit Committee.** To secure the significant degree of independence which would be necessary consequent upon this reallocation of audit work, the chief internal auditor should report to a Financial Reporting and Audit Committee (FRAC) made up entirely of non-executive directors. The proposed FRAC would be similar to existing audit committees but would have additional functions and responsibilities.

• **Change in role of external auditors (assessors).** The establishment of an enhanced internal audit function with responsibility for carrying out the bulk of the financial auditing work would mean that it would no longer be necessary for the external auditors to carry out much of their existing work since by so doing they would be merely replicating what had already been carried out by the internal auditors. The work carried out by the external auditors would, therefore, become more judgmental and less procedural than that carried out at the present time. To reflect this, ICAS (1993) proposed a change in name from external *auditors* to external *assessors.* The external assessors would be principally responsible for reporting their opinions regarding the establishment and maintenance of appropriate management information systems, the truth and fairness of the financial statements and the going concern status of the company.

A fourth major proposal followed from the belief that it was necessary to strengthen external auditor (or assessor) independence:
Establishment of ARP. It was proposed by ICAS (1993) that an independently constituted ARP should be established to take responsibility for the appointment (and termination of appointment) of the external assessors, agreeing the remuneration and for generally supervising the assessment process on behalf of the primary stakeholders.

These proposed structures and reporting obligations are summarised diagrammatically in Figure 2.1.
Figure 2.1: Corporate governance structures proposed by ICAS (1993)

Key:
- = report
- - = supervise
- - - - - = liaise

* Appointed by shareholders
** Appointed by ARP
*** Appointed by FRAC
The viability of the ICAS (1993) proposals would be heavily dependent on the practicability of implementing the detailed provisions concerned with audit committees (or FRACs) and internal audit. These bodies are, therefore, given significant attention in this report.

**Current corporate governance structures in the UK and the Netherlands**

Different corporate governance models exist throughout the world as a result of different cultural, legal and corporate environments. The Dutch system is quite distinct from that which has existed in the UK since the early development of incorporated companies.

The UK

The UK has adopted a unitary board, comprising both executive and non-executive directors. The chairman of the board is normally a non-executive director. While executive and non-executive directors have different functions within the company, all directors have collective responsibility legally for the decisions of the board. The responsibilities of the board include setting the company's strategic aims, providing leadership to put them into effect, supervising the management of the business and reporting to shareholders on its stewardship (Cadbury, 1992). Audit committees have been established for longer in the UK than in the Netherlands and increasingly are composed solely of non-executive directors. Internal audit, however, has not traditionally enjoyed the same status as in the Netherlands. The main components of the UK system of corporate governance are shown in Figure 2.2.
Figure 2.2: Current corporate governance structures in the UK

Key:

= report
- - = supervise
- - - - = liaise

* Appointed by shareholders
** Appointed by board of directors
The Netherlands

The corporate governance structure adopted in the Netherlands is founded on a two-tier board system with an explicit separation between supervision and management. Supervision duties are undertaken by a supervisory board which cannot take part in the active management of the company, whilst the board of management is responsible for managing the company. For large companies a supervisory board is a requirement; in the case of other companies this is optional. Audit committees exist in some Dutch companies but, in general, these are not as long established as in the UK and effectively the audit committee is a sub-committee of the supervisory board. A prominent feature of Dutch corporate governance is the high status enjoyed by the internal audit function. Traditionally, an important role of internal audit has been the certification of the financial statements in a similar fashion to the external auditor. There are, therefore, close parallels between Dutch practice and some proposals in *Auditing into the Twenty-first Century*. The main components of the Dutch system of corporate governance are shown in Figure 2.3.
Figure 2.3: Corporate governance structures in the Netherlands

Key:

- = report
- - = supervise
- - - = liaise

* Appointed by shareholders
** Appointed by supervisory board
*** Appointed by board of executive directors
Cultural factors affecting corporate governance and accounting

There are significant differences in corporate governance structures in the UK and the Netherlands. However, structures may be distinguished from cultures. The former are identified relatively easily and are often defined by statute or by quasi-legal requirement. The latter are less easily identified as differences in corporate culture between societies are more subtle. Arguably, at the most fundamental level, the corporate culture of the UK is an example of an Anglo-American or market-oriented approach, while the Netherlands is an example of a continental or consensus approach. However, the culture (and accounting sub-culture) of the Netherlands exhibits some unique features. One Dutch publication (Blokdijk et al. 1995) argued that, while the Dutch are inclined to accept social control, 'heavy-handed approaches to securing conformity with laws and rules will be met with opposition'. Hofstede (1984; 1985) characterised Dutch society as feminine and one in which conflict is resolved by negotiation in contrast to the societies of the UK and the US which Hofstede conceptualises as masculine and confrontational. Table 2.1 shows some cultural and economic factors affecting corporate governance systems in the UK and the Netherlands based on these considerations and the arguments of Wallage (1995).

Table 2.1: Summary of factors affecting corporate governance systems

<table>
<thead>
<tr>
<th>UK</th>
<th>NETHERLANDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>'centrality of market' culture</td>
<td>'consensus' culture</td>
</tr>
<tr>
<td>market oriented</td>
<td>network orientated</td>
</tr>
<tr>
<td>short-term strategy</td>
<td>long-term strategy</td>
</tr>
<tr>
<td>relatively more equity</td>
<td>relatively more debt</td>
</tr>
<tr>
<td>stock exchange relatively large</td>
<td>stock exchange relatively small</td>
</tr>
<tr>
<td>relatively less influence of the</td>
<td>relatively more influence of</td>
</tr>
<tr>
<td>private shareholder</td>
<td>the private shareholder</td>
</tr>
</tbody>
</table>
It has been argued that the Dutch culture of consensus and compromise has influenced fields such as business, accounting and auditing by creating an aversion to rigid and detailed standards. Paradoxically, however, the small size and cohesiveness of Dutch business society creates an interesting juxtaposition whereby this absence of detailed standards co-exists with a large degree of uniformity. In accounting, much of this uniformity of approach may be due to the strong influence of ‘business economics’ which as a cohesive set of theories owes much to the work of Theodore Limperg (1879-1961). Accounting in the Netherlands, therefore, may be characterised as possessing less flexibility than accounting in the UK where minimal statutory control and the absence of a strong academic tradition has allowed the profession to determine much of best practice.

It is important, however, not to exaggerate the extent of these differences. Differences may be more significant in terms of general corporate governance rather than in terms of financial reporting and audit. Approaches to classifying national accounting systems commonly recognise at least a degree of similarity between the forms of accounting adopted in the two countries. For instance, Nobes (1984) judgmentally classified the accounting systems of fourteen countries into two groups: microeconomic and macroeconomic. Nobes classified the accounting systems of both the UK and the Netherlands as microeconomic. This classification subsequently received strong support from empirical work carried out by Dooupnik and Salter (1984). Hermann and Thomas (1995) grouped the Netherlands and the UK with Denmark and Ireland as ‘fairness-orientated’ countries.

Problems generating the corporate governance debate and responses by regulators

The worldwide debate on corporate governance has raised concern over a number of perceived weaknesses which may make one key aspect of governance, that of accountability, more problematic. Following a number of perceived audit failures, concern has been expressed regarding the level of credibility of financial information provided to meet the
needs of stakeholders. This, however, is not a new development; historically the profession has encountered difficulty in reconciling public expectations with audit practice. There remains a considerable gap between what stakeholders think auditors do and what auditors think auditors do.

Whittington (1993) identified the following problems as fundamental to the debate on corporate governance which took place in the UK in the early 1990s:

Creative accounting: During the 1980s, corporate management went to considerable lengths to present accounting performance in an unduly favourable light (eg Griffiths, 1986). The implicit assumption was either that shareholders could be fooled or, at least, that directors believed that they could be (despite the presumed existence of semi-strong efficient capital markets). In any event, there appeared to be a failure in the capacity of shareholders to control directors.

Business failures and scandals: In the late 1980s and early 1990s a series of failures and scandals suggested a failure of existing arrangements for corporate governance and, consequently, an associated criticism of accounting and auditing. These scandals led to a wider debate about the roles of non-executive directors and auditors although it is clear that no system of corporate governance can provide a protective guarantee against business failure or fraud.

Directors’ pay: This was a particular issue in regard to the privatised utilities and also the phenomenon of directors’ stock options in a rising stock market.

Short-termism: It was alleged that short-term pressures imposed by the stock market led to failure by industry to invest for the long term. This occurred in the context of an academic literature which focused on what were argued to be limits to stock market efficiency.

These problems were regarded as serious because of the increasing importance of institutional shareholders (see Gaved and Goodman, 1992) who tend to be passive in corporate governance matters other than in extreme situations. Moreover, there were perceived deficiencies in the independence of auditors who are expected to partially compensate for at least the irregularities in financial reporting.
The ensuing corporate governance debate resulted in a significant reaction by the accountancy profession. The most significant UK responses for the purposes of this report are *The Cadbury Report* (1992) and *The McFarlane Report* (APB, 1992). These documents were both important to *Auditing into the Twenty-first Century*. There have, however, been a number of other key documents on corporate governance issued in the UK during the 1990s. As these have implications for the present research project, they are described briefly in Table 2.1.

**Table 2.2: Summary of key documents on corporate governance issued in the UK during the 1990s**

<table>
<thead>
<tr>
<th>Title</th>
<th>Key Content</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>The McFarlane Report</em> (APB, 1992)</td>
<td>Proposed a redefinition of the role and scope of the audit to incorporate a focus on the management of financial risks, more informative reporting by auditors and reporting to a wider constituency of stakeholders. Discussed the need to enhance auditors' independence.</td>
</tr>
<tr>
<td><em>The Cadbury Report</em> (Cadbury, 1992)</td>
<td>Aimed to improve information to shareholders, reinforce self-regulation and strengthen auditor independence. Recommended that the boards of directors should report on the effectiveness of companies' systems of internal control and that each listed company should establish an audit committee of at least three non-executive directors.</td>
</tr>
<tr>
<td><em>Auditing into the Twenty-first Century</em> (ICAS, 1993)</td>
<td>Outlined earlier in chapter.</td>
</tr>
<tr>
<td><em>The Audit Agenda</em> (APB, 1994)</td>
<td>Developed the McFarlane Report. Proposed that the scope of audit for listed companies be extended to include reporting on governance issues and made various audit recommendations relating to fraud and the responsibilities of audit committees.</td>
</tr>
<tr>
<td><em>The Hampel Report</em> (Hampel, 1998)</td>
<td>Developed the <em>Cadbury Report</em>. Recommended that the auditors report on internal control privately to the directors; directors maintain and review controls in general and not merely financial controls; and companies that do not already have an internal audit function should from time to time review the need for one. Introduced the Combined Code that consolidated the recommendations of extant corporate governance reports.</td>
</tr>
<tr>
<td><em>The Turnbull Report</em> (ICAew, 1999)</td>
<td>Provided guidance to assist companies in implementing the requirements of the Combined Code relating to internal control. Recommended that where companies do not have an internal audit function, the board considers the need for one annually. Recommended that boards of directors confirm the existence of procedures for evaluating and managing key risks.</td>
</tr>
</tbody>
</table>
The table indicates that the views expressed in *Auditing into the Twenty-first Century* have been reinforced by subsequent professional pronouncements. For instance, both *The Hampel Report* (Hampel, 1998) and *The Turnbull Report* (ICAEW, 1999) recommended that companies not already having an internal audit function periodically consider the need for one.

Internal control is a continuing theme of the contemporary debate on corporate governance, highlighted by *The Cadbury Report* (1992) and *The Hampel Report* (1998). There is now general recognition that this is a central corporate governance issue for shareholders. Different definitions of internal control have been adopted; there has been gradually increasing support for the view that the scope of internal control should embrace non-financial, as well as financial, control.

There has also been a recent and separate debate on corporate governance in the Netherlands. The immediate cause of this debate was a discussion about the existence of heavy barriers for hostile takeovers and the question of how much say shareholders should have in the governance of a company in the broadest context. As a result of an agreement between the Association of Securities Issuing Companies and the Amsterdam Stock Exchange, a Committee on Corporate Governance (the Peters Committee) was set up in April 1996. In June 1997, the Committee published its final report (*The Peters Report*, 1997), which contains 40 recommendations focused primarily on the role, tasks and responsibilities of management, supervisory board and shareholders. The report has not been adopted formally by the Amsterdam Stock Exchange, though companies can choose to adopt the recommendations voluntarily.

**Summary**

This chapter has outlined the proposals made by *Auditing into the Twenty-first Century*. These proposals were made in the specific corporate governance context of the day and this chapter has examined changes in the corporate governance context since then. The Dutch dimension to the research, has also made it necessary to examine the nature of corporate
governance in the Dutch setting. The structures and cultures of corporate governance in each country have been compared. Important differences in corporate governance in each country include:

• two-tier (Dutch) versus unitary (UK) board system;
• greater relative status of internal audit in the Netherlands; and
• longer history of audit committees in the UK.

The following three chapters examine literature on these internal monitoring bodies (audit committees, internal audit and supervisory boards).

Endnotes:

1 Another prominent feature of the corporate governance structures of larger companies is the works council, whose purpose is to permit the workforce to debate important issues with the executive board. Works councils have no significant implications for the audit function and are not considered further in this report.

2 There have also been responses from the academic community to issues of corporate governance in the form of radical proposals written from a 'critical' perspective (eg Sikka et al. (1992)); these are not considered further in this report.
CHAPTER THREE

LITERATURE REVIEW: AUDIT COMMITTEES

This chapter first sets out the main ICAS (1993) proposals relating to audit committees (ie those relating to the ARP and FRAC). It then reviews the literature on audit committees in relation to: their history and development; functions and responsibilities; composition; time spent; assessment of effectiveness; and the means by which audit committees assess internal and external audit. The means by which audit committees assess internal and external audit quality is also addressed. A final section offers comment and identifies key issues for investigation at the fieldwork stage.

ICAS (1993) proposals relating to audit committees

To ensure that the internal auditors have a significant degree of independence from the executives we propose that, in addition to reporting to the Chief Executive, the Chief Internal Auditor should report to a Financial Reporting and Audit Committee (FRAC) made up entirely of non-executive directors. The FRAC should approve the appointment, and the termination of the employment, of the Chief Internal Auditor. The Chief Internal Auditor should be free to communicate with the external assessors at any time. (ICAS, 1993, para.5, p56)

To ensure that the external assessors are independent of, and are clearly seen as being independent of, the directors of the companies they assess, we propose that an Audit Review Panel should take responsibility for the appointment, and the termination of the appointment, of the external assessors. The Panel should also take responsibility for agreeing the remuneration of the assessors. (ICAS, 1993, para.9, p57)
The ICAS discussion document proposed that the ARP, be composed of possibly three members, drawn from a list of suitable candidates maintained by the Stock Exchange. It was anticipated that the ARP would have responsibility for supervision of the assessment process on behalf of the primary stakeholders and would ensure that the assessors had acted in the interest of the primary stakeholders. Zeff (1998) argued that the interposition of an ARP ‘serves to compensate for the illusion that the board of directors sits as an objective judge of management and that its actions are taken in the best interests of shareholders’. The proposal relating to the ARP would involve a considerable modification of the current corporate governance structure, but is similar to the audit panel suggested by The McFarlane Report (APB, 1992).

The APB (1994) reported, however, that there was little support from respondents for an audit panel of this type, due to concern that this would merely add another bureaucratic layer of governance. It was believed that an audit committee set up in accordance with the Cadbury Code of Best Practice should be able to undertake many of the functions envisaged by such a panel. Nevertheless, the APB considered that judgment on this issue should be suspended until more conclusive evidence was available and proposed further research into the concept of communication between auditors and shareholders through committees or panels.

**History and development**

The recommendation of the Cadbury Committee that all listed companies should establish an audit committee was based on experience in the US and Canada where audit committees appear to have proved their worth and developed into essential committees of the board (eg CICA, 1988; Verschoor, 1992). Audit committees are argued to enhance audit quality and to improve the effectiveness of the monitoring of directors by shareholders.
The UK

Audit committees in the UK have their roots in the 1970s and the first UK article on the subject, which argued that audit committees were a North American phenomenon, appeared in 1974 (Beedle, 1974). Few UK companies had formed audit committees by 1977 (Chambers and Snook, 1979). By 1991, in the region of 50% of major UK companies had established audit committees (Collier, 1992).

Further research by Collier (1993) indicated that major companies with an audit committee had a lower proportion of their share capital owned by directors, a higher level of gearing and more non-executive directors than comparable companies which did not have audit committees. These variables noted by Collier may be conceptualised as representative of agency costs which derive from the inherent conflict of interest between principals (shareholders or other stakeholders such as debt holders) and agents (directors in the present context). The establishment of an audit committee can reduce the agency costs of equity and debt resulting from the above mentioned conflicts of interest. It can also reduce the costs of information asymmetries between directors and stakeholders. Agency theory is expounded generally by Jensen and Meckling (1976) and by Wallace (1980) in an audit context.

The UK evidence suggests that audit committees have been established either to provide a ‘buffer of independence’ between the auditors and the executive directors in general terms or to examine and monitor auditor performance and issues of control, again in broad terms only (eg Collier, 1992).

The Netherlands

In the Netherlands, Wagner, president of the supervisory board of Shell, recommended the introduction of audit committees in 1978. He had appreciated the value of audit committees during his work for Shell in Canada and the US. He recommended, therefore, the adoption of a Dutch audit committee which should focus on the scope of the external audit, the quality of the internal financial information system, and the results of the audit. He recommended that the audit committee meet
three or four times a year and argued that its work would lead to a better understanding and communication between management, external auditors and the supervisory board. In addition, he hoped that the quality of the annual accounts would improve, as well as the confidence of ‘the public’ (Wagner, 1978).

The development of audit committees in the Netherlands occurred later than in the UK or US (van Moerkerk, 1992). In a FINEM report (van Moerkerk, 1992), an audit committee is described as ‘a committee mostly existing of members of the supervisory board, board of management and in some cases the chief internal auditor’. The external auditor is mentioned as attending most of the meetings. According to this report, the purpose of such a body is to promote regular contact between the supervisory board and the auditors. In most cases, management attends the meetings. Unusually, internal auditors viewed the audit committee as primarily rendering services to the board of management. This is surprising, especially in the context of the Anglo-American model where non-executives are central to the work of audit committees which are, in turn, grounded in a broader ethos of corporate governance.

Audit committees are now becoming more familiar in large Dutch corporations with international interests. Breedveld-Krans (1991) found that audit committees had been established in 34% of the corporations which participated in her survey. Based on the findings of van Moerkerk (1992), however, it may be assumed that almost 50% of the larger companies have established an audit committee. It is likely that an audit committee is limited to larger companies, particularly those within the financial sector and those listed on the Amsterdam Stock Exchange. Van Lede (1994), chairman of the board of directors of AKZO, stated that his experience with the audit committee of AKZO had been good. Van Lede also argued for regular meetings between the audit committee, members of the supervisory board and the external auditors in the absence of the management, once or twice a year, or whenever needed.
The US and Canada

Audit committees were developed initially in North America and, since 1978, the New York Stock Exchange (NYSE) has required all listed companies to have audit committees composed solely of independent directors. In addition, the Treadway Commission (1987) concluded that audit committees had a critical role to play in ensuring the integrity of company financial reports. Verschoor (1992) has expressed the view that the establishment of standing audit committees of the board of directors followed by their greater assumption of oversight responsibilities is the most significant development affecting corporate governance in this century. In Canada, The McDonald Report (CICA, 1988) argued that effective audit committees were a valuable channel of communication between auditors and corporate boards. It also argued that their importance was likely to increase in the future to the extent of being a feature of the corporate governance environment which would be taken into account by the courts (CICA, 1988 para. 9.15). The importance given to audit committees in the US has been re-emphasised with the establishment in September 1998 of The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees sponsored jointly by the NYSE and the National Association of Securities Dealers (The Blue Ribbon Report). This action was taken in response to concerns expressed by the Securities and Exchange Commission (SEC) chairman Arthur Levitt about the adequacy of the oversight of the audit process by independent corporate directors. The committee’s findings and recommendations are aimed at enhancing the independence, effectiveness and accountability of audit committees (NYSE/NASD, 1999).

Functions and responsibilities

This section outlines the functions and responsibilities of audit committees in the UK, the Netherlands and, to a lesser degree, the US.
The UK

The situation pre-Cadbury is considered first, followed by the Cadbury proposals and the situation post-Cadbury.

Pre-Cadbury

Marrian (1988) investigated the formation and role of audit committees among The Times 1000 industrial companies. Seventeen percent of respondents indicated the existence of an audit committee. Marrian noted that audit committees had often been established from general motives such as giving support to the finance director or because directors thought it was the proper thing to do. He stated that the audit committees' functions included, for instance, the review of audit plans for internal and external auditors and the review of financial statements prior to presentation to the main board.

Later, Collier (1992) conducted an extensive survey into audit committees among the top 250 companies of The Times 1000. His findings suggested that the number of functions assigned to audit committees by 1991 had increased considerably from those noted in Chambers and Snook (1979). Some of the most important functions assigned to audit committees were (percentage of audit committees having function assigned shown in parentheses):

- discussion with the auditors of their experiences and problems in carrying out the audit (97%);
- review of the external auditors' evaluation of the company's internal control systems (93%);
- discussion of the effectiveness of internal controls (84%);
- review of internal audit objectives and plans (82%); and
- discussion of the relationship between internal and external auditors and the co-ordination of their audit work (69%).

Collier's findings suggest that audit committees would be able to fulfil the enhanced role assigned to them under the ICAS (1993) proposals.
**Cadbury Committee proposals**

The report of the Cadbury Committee regarded the appointment of properly constituted audit committees as an important step in raising standards of corporate governance (Cadbury, 1992, 4.37), recommending that all listed companies should establish one (Cadbury, 1992, 4.35). Cadbury (1992) suggested that the duties of the audit committee should be determined in the light of the company’s needs but should normally include:

- making recommendations to the board on the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;
- review of the half-year and annual financial statements before submission to the board;
- discussion with the external auditor about the nature and scope of the audit, any problems or reservations arising from the audit, any matters which the external auditor wishes to discuss without executive board members present, and co-ordination where more than one audit firm is involved;
- review of the external auditor’s management letter;
- review of the company’s statement on internal control systems prior to endorsement by the board;
- review of any significant findings of internal investigations; and
- review of internal audit programme where an internal audit function exists.

**Post-Cadbury**

Following *The Cadbury Report*, the APB (1994), suggested in *The Audit Agenda* that the audit committee, as a proxy for shareholders, should have responsibility for the appointment, accountability and remuneration of external auditors and for approving non-audit work undertaken by them. Under the ICAS (1993) proposals, some of these functions would be performed by the ARP rather than by the audit committee. The APB also recommended that the Chairman of the audit committee should
report to primary stakeholders on matters relating to the appointment and remuneration of auditors, both in writing and orally in general meeting. The APB argued that when making recommendations to shareholders on audit appointments, audit committees should ensure that appropriate quality will be maintained at a cost which provides value for money, bearing in mind shareholders’ expectations. The APB admitted, however, that even audit committees whose membership consisted solely of non-executive directors would be constrained, to some degree, in the extent to which they can be regarded as a proxy for shareholders and independent of executive directors. This implies that implementation of The Audit Agenda may still leave scope for the implementation of the ICAS (1993) proposals relating to the ARP.

Collier (1997) suggested that one role for audit committees may be to assist directors to meet their statutory and fiduciary responsibilities. There has also been evidence of professional support for the view that audit committees should exercise a leadership role in the increasingly important area of risk management and assessment of internal control in the widest sense (Bruce, 1997c; Scicluna, 1997)

The Netherlands

An important function of the Dutch audit committee is to formalise contact between the supervisory board and the external and internal auditors. It is argued that the audit committee strengthens the position of the supervisory board and the independent position of the internal and external auditors (Van Moerkerk, 1992; De Mare, 1993).

From a formal perspective, the audit committee’s tasks are stipulated to be the responsibility of the supervisory board. Large Dutch companies, however, with many supervisory board members, have started to introduce sub-committees of the supervisory board. The audit committee, remuneration committee and the nomination committee are the most important examples. It is the supervisory board as a whole, however, that takes formal decisions, and consistent with this the audit committee formally reports to the supervisory board.
The Peters Report (1997) recommended that the specific duties of the audit committee, as a sub-committee of the supervisory board, include:

- supervising the quality of all external financial reports;
- supervising compliance with internal procedures, laws and regulations and the control of company risks;
- facilitating communication with the auditors; and
- assessing the activities and functioning of the auditors.

The US

Verschoor (1989) identified oversight functions covering the following broad areas: activities related to internal control systems; financial reporting activities; activities involving external auditing; activities related to internal auditing; and activities involving corporate governance. Audit committee functions are suggested under each heading; however no detail is given to the actual extent to which these functions are exercised by audit committees.

In a later paper, Verschoor (1993) reported the results of a survey by the US General Accounting Office of 40 of the largest banks’ audit committee chairpersons. Ninety-five percent agreed that their committees were responsible for reviewing the adequacy of the internal control structure, for supervising the internal audit function and for assessing the adequacy of the external auditor’s performance. However, 35% of the audit committees in the surveyed institutions contained no members with auditing or accounting expertise. It may be a reflection of this that 95% of chairpersons reported placing great or very great reliance on the work and expertise of their external auditors in determining the effectiveness of the oversight activities of the audit committees. In addition, in 83% of cases the regular annual financial statement audit was expected to identify all significant internal control weaknesses.

Vinten and Lee (1993), in discussing audit committee functions and responsibilities in the UK and US, stated that primary functions included review of the financial affairs of the institution, review of the financial statements and oversight of all audit functions in the company. The Blue
Ribbon Report (NYSE/NASD, 1999) places emphasis on the importance of independent communication and information flow between the audit committee and both external and internal auditors. This emphasis highlights the importance of mechanisms for accountability among the audit committee, external and internal auditors, and management.

**Composition**

This section considers the composition of audit committees in the UK, the Netherlands and the US.

**The UK**

The situation pre-Cadbury is considered first, followed by the Cadbury proposals and the situation post-Cadbury.

**Pre-Cadbury**

Collier (1992) discovered that for 53% of the companies surveyed that had audit committees, membership of the audit committee was restricted to non-executive directors, with the remaining companies including executive directors on their audit committees. This finding confirmed previous research by Chambers and Snook (1979) and Marrian (1988). The inclusion of executives is likely to be a matter of deliberate policy in some cases; elsewhere there may be an insufficient number of non-executive directors available to ensure a viable audit committee. An important consideration is whether such companies would be able to restructure their audit committees satisfactorily in the event of the ICAS proposals being implemented.

*The McFarlane Report* (APB, 1992), however, expressed reservations about audit committees composed of non-executive directors. The report expressed concern that:
... because the members are non-executive directors bound by the concept of unitary board responsibility, audit committees may themselves, albeit unwittingly, be subject to conflicts of interest in matters relating to the audit equivalent to those currently held to jeopardise auditors' independence.

Jack (1993) argued that financial expertise on the part of audit committee members is vital. It is possible that many companies would find it difficult to establish an audit committee with the necessary expertise particularly bearing in mind the additional constraint of non-executive status. Collier (1993) indicated that several companies in his survey stated that they had insufficient non-executive directors with the relevant skills.

**Cadbury Committee proposals**

The Cadbury proposals recommended that an audit committee should have a minimum of three members. It argued that membership should be confined to the non-executive directors and that a majority of the non-executives should be independent. It also suggested that the external auditor and the financial director should normally attend audit committee meetings. Furthermore, as the board as a whole is responsible for the financial statements, other board members should have the right to attend. In addition, where an internal audit department exists, the head of internal audit should normally attend the audit committee meetings. Cadbury also suggested that membership of an audit committee is a demanding task requiring commitment, training and skill. Consequently, the directors concerned need to have sufficient understanding of the issues to be dealt with by the committee to take an active part in its proceedings.

**Post-Cadbury**

Hosking (1994) noted that research carried out in 1994 by Pensions Investment Research Consultants on the 250 largest quoted companies in the UK found that only thirteen of these had executives on the audit
committee. Where an audit committee included executive directors, there were often other barriers to membership. Most commonly, there was a bar on the chairman serving on the audit committee, although Hosking (1994) noted five companies whose chairman served on the audit committee and a further three instances where all executive directors were members of the committee. A substantial minority of companies, therefore, included persons other than non-executives on their audit committees. No definite reasons for this could be identified, although one chief executive defended his position on the audit committee by stating that ‘topics occur where you have to have an executive present to explain day-to-day procedure’ (Hosking, 1994). Attendance, however, does not necessarily imply membership.

In May 1995, the monitoring sub-committee of Cadbury (Cadbury, 1995) issued a report which indicated that over 80% of companies in the top 250 stated that they complied with the requirement to have an audit committee comprising three non-executive directors. There already exists, therefore, a substantial foundation for the implementation of the ICAS (1993) proposal that audit committees should be composed solely of non-executives.

Whilst The Audit Agenda (APB, 1994) was supportive of the Cadbury proposals, it suggested that an audit committee consisting of non-executive directors would be constrained, to some degree, in the extent to which it could be regarded as a proxy for shareholders and be independent of executive directors. However, it did suggest that appropriately qualified members should be able to fulfil an effective role in ensuring that the shareholders’ viewpoint is represented in board discussion.

Mitchell et al. (1993) did not agree with the Cadbury proposals on the appointment of audit committee members. They proposed that audit committees should not be composed of ‘non-executive directors, hand-picked by the Board’. Instead, they should be elected directly by various stakeholders (eg consumers, employees) and be accountable directly to them. Their powers should be clarified in law and they must be seen to act as effective contributors to corporate governance.

Mitchell (1993) pointed out that the requirement to restrict the membership of the audit committee to non-executives may not be sufficiently rigorous. Non-executives may hold shares, options for shares,
or have other interests in the company or may previously have been senior executives. It has been suggested that, to a significant extent, non-executive directors may be involved in related party transactions linking either themselves or their families with the companies. It may, therefore, become necessary to identify the scale of these problems. Gwilliam and Kilcommmins (1998) identified that some users of financial statements in Ireland had significant reservations regarding the independence of non-executive directors serving on Irish audit committees.

The Netherlands

The audit committee is established by the supervisory board to supervise the work of the internal and external auditors. In practice, the board of management, or the chief executive, is involved informally in establishing the audit committee. The audit committee consists of a mixture of supervisory board members, representatives of financial management and the internal audit department. According to De Mare (1993), the president of the supervisory board should also be president of the audit committee. Surprisingly, van Moerkkerk (1992) found that in several audit committees the supervisory board was not represented.

In contrast to Anglo-American practice, in Dutch companies the audit committee generally consists of more than five members (van Moerkkerk, 1992). Another important difference is the profile of audit committee members. Generally, Anglo-American committees consist of non-executive directors or at least contain a substantial number of non-executive directors. In these countries it has been argued that audit committees should include general managers and should be able to draw on a range of financial, marketing, technical and legal expertise. According to van Moerkkerk (1992), Dutch internal auditors had mixed views about the added value of admitting external experts to the audit committee. If committee members between them have a broad range of experience, then this should ensure that the audit committee provides a useful counterbalance to the board of management.
The US

There are various requirements and recommendations regarding the membership of audit committees. The NYSE requires all listed companies to have an audit committee composed solely of non-executive directors (Cooper, 1993), while the American Stock Exchange recommends this (Rezaee and Lander, 1993). Verschoor (1993) indicated that, from 1993, Federal Deposit Insurance Corporation guidelines directed that the boards of banks and savings institutions select for audit committees only outside directors who are independent of management. In addition, a report by the American Law Institute recommended that outside directors who are members of audit committees be ‘free of any significant relationship’ (emphasis added) with the senior executives of the corporation.

Research by Abdolmohammadi and Levy (1992) is also relevant to companies which presently do not have audit committees. They argued that, regardless of the composition of audit committees, it takes time for members to feel confident about their jobs and to begin to contribute significantly to the committee’s activities. They suggest that changes in audit committee membership be avoided for at least the first five years. These arguments may support a view whereby implementation of the ICAS (1993) proposals should only be executed gradually and after an acclimatisation period allowing audit committee members to familiarise themselves with their roles.

Independence

The problem of independence has been examined in the US by Vicknair et al. (1993) who presented evidence indicating that ‘grey area’ director representation on audit committees is pervasive across NYSE firms and over time. Grey area directors are defined as those who, although not employed by the corporation on whose board they serve, are affiliated to it or with its management. In this situation, there may be problems with the independence of non-executive directors, even in the absence of any direct or indirect financial interest in the companies on whose audit committees they serve.
The Blue Ribbon Report (NYSE/NASD, 1999) has recommended the adoption of a new stricter definition of independence as a qualification for service on audit committees of large listed companies. Examples of relationships which are deemed to be incompatible with this definition include a director who has been employed by the corporation or its affiliates within the last five years and a director who has a significant involvement in a business organisation which has been involved in significant cash transactions with the corporation within the last five years. This recommendation may be viewed as an attempt to deal with the problem of 'grey area' directors. The Blue Ribbon Report has also recommended that all audit committee members should be financially literate (or should become so within a reasonable period of appointment) and that at least one member should have accounting or related financial management expertise. Similarly, Kalbers and Fogarty (1993) indicated that financial expertise is needed for audit committees to operate effectively.

**Time spent**

This section covers the number of meetings per annum and their duration in the UK, the Netherlands and the US and Canada.

**The UK**

The situation pre-Cadbury is considered first, followed by a statement of the Cadbury proposals and related comments.

**Pre-Cadbury**

Evidence from Collier (1992) suggested that the most commonly occurring number of meetings was two (37 companies out of 102 replying). Only ten held more than four meetings per year with the maximum number being six. Fifty-five companies held three or four meetings per year. The maximum time quoted by a company for the average duration of a meeting was four hours and the mean average time
was two hours. The overall annual average for the total time spent by audit committees in meetings was, therefore, between six and seven hours. In view of the wide range of audit committee responsibilities noted previously, this evidence suggests that generally audit committees did not discuss or examine the topics in any depth.

**Cadbury and post-Cadbury**

Cadbury (1992) suggested that the audit committee should normally meet at least twice a year. In the report, *The Future of Britain’s Board of Management: Two Tiers or One?* Sir Geoffrey Owen of the London School of Economics concluded that because of the substantial time commitment required, non-executives should limit the number of boards of which they are members (Owen, 1995).

**The Netherlands**

It is recommended in the Netherlands that the audit committee meet at least twice a year (Audit Committees 1977 nrs 1-33). It is suggested that one meeting is held prior to the start of the financial audit, to review the audit plan, and the other is held shortly after completion of the audit, to discuss the results of the audit and the annual financial statements. If the circumstances require it, or if necessary because of the type or size of the corporation, the number of meetings should be extended. This might be when the auditors have completed the interim audit work, or when a special meeting to review the work of the internal auditors is necessary. According to van Moerkerk’s questionnaire study (1992), the most commonly occurring number of meetings per year was two. *The Peters Report* (1997) recommended that at least one meeting per year be held between the external auditor and the supervisory board or audit committee.
The US and Canada

Verschoor (1992) reported that in the US audit committees in the companies surveyed held an average of four meetings per year. The average duration of meetings was slightly shorter than in the UK with each lasting, on average, one hour and 45 minutes, with the range being from 30 minutes to six hours. Although the number of meetings held is on average twice that of the UK or the Netherlands, this level of commitment still suggests that in many cases audit committee meetings do not involve in-depth discussions.

If audit committee members are unable to devote the necessary time commitment, an alternative approach may involve delegation of the monitoring of financial statements to a committee composed of outsiders. Guertin (1991) examined this in a Canadian context and concluded that the overall management and monitoring quality of organisations adopting this approach would be reduced. No recent evidence regarding the time spent by Canadian audit committees appears to exist.

Assessment of effectiveness

Cadbury (1992) suggested that if audit committees operate effectively they could bring significant benefits to companies. These potential benefits include: improving the quality of financial reporting; creating a climate of discipline and control within the company which will reduce the opportunity for fraud; strengthening the position of both the internal and external auditors; and increasing public confidence in the credibility and objectivity of financial statements.

In addition, The Audit Agenda (APB, 1994) suggested that an audit committee can provide a constructive challenge to the executive directors on matters relating to the adequacy of the company's financial reporting and the soundness of the systems put in place to minimise the risks of fraud and other irregularities. Additionally, the audit committee provides a means of conducting direct dialogue between the auditors and shareholders. In view of these potential benefits, assessing the effectiveness of the audit committee is of critical importance.
The following issues relating to the effectiveness of audit committees have been identified and are addressed below:

- What constitutes effectiveness?
- Is there evidence that existing audit committees are effective?
- Are there criteria that might be used to assess effectiveness meaningfully and is there evidence of such criteria being used presently?

**What constitutes effectiveness?**

Although there appears to be a general impression that audit committees are an effective mechanism of corporate governance, relatively little thought appears to have been given to the constituents of effectiveness. Much of the argument for audit committee effectiveness is couched in general or anecdotal terms. The likelihood of measuring audit committee effectiveness may depend, to an extent, on the degree to which the objectives of the audit committee are formulated clearly.

**Input or output approach**

There is no clear consensus in the literature regarding the appropriate vehicle for measuring effectiveness eg whether an input or an output focused approach is most suitable. The former has clear limitations. Kalbers and Fogarty (1993), for instance, state that 'defining effectiveness solely as the execution of a series of tasks, however exhaustive, fails to measure the level of quality with which they are performed' (original emphasis). Audit committee 'output', however, may be intangible in many cases and therefore immeasurable. Kalbers and Fogarty view effectiveness as 'the competency with which the audit committee carries out its specific oversight responsibilities' and focus specifically on audit committee *power* as a necessary antecedent to effectiveness. This approach, while it attempts to compensate for the deficiencies of a simple input approach, stops short of measuring measurable outputs and might therefore be deemed to be incomplete.
From a more fundamental perspective, some literature now questions whether audit committees can ever really be effective, particularly in the way envisaged by Cadbury (1992). Collier (1996) noted the difficulty of defining the concept of effectiveness or the criteria by which it might be assessed. There is also a literature on organisational effectiveness which discusses extensively the problem of defining effectiveness. Cameron (1984) indicated that it was easier to identify ineffectiveness when it exists than to identify effectiveness criteria.

**The link with auditor independence**

The concept of independence is central to more traditional ideas of audit committee effectiveness. Cadbury, for instance, assumes a link between audit independence, as underpinned by audit committees, and an enhancement in the quality of financial reporting. Almost all work to date (eg Jackson-Heard, 1987; Schleifer and Shockley, 1990; Beattie et al. 1999) suggests that audit committees enhance the perceptions of the users of financial statements with respect to auditor independence.

Auditing literature, however, (eg Reiter, 1997) has begun to demonstrate a degree of disillusionment with the concept of independence. Grout et al. (1994) argued from an economic perspective that a degree of auditor dependence on clients might improve the quality of financial reports. Wolnizer (1995) argued that “the presumption that any steps taken to strengthen the independent status of auditors will lead of themselves to more ‘objective’ financial statements is unfounded”. He argued that the setting up of audit committees by themselves is a ‘red herring’. Spira (1997) drew on this literature and concluded that audit committees cannot work in the terms envisaged by Cadbury.

**The UK**

Important factors that constitute effectiveness were highlighted in a UK context by Lindsell (1993), who indicated in a review of Jack (1993) that audit committee members who understand little about the financial reporting process are unlikely to be effective committee members. Lindsell
made the point that this is particularly likely to be the case given the strictly limited time which most audit committees spend in meetings. Elsewhere, Lindsell (1992) gave his views on what constitutes the effectiveness of audit committees. These included: the investment of the audit committee with sufficient authority; clear terms of reference and responsibilities set out in writing; a sufficiently wide range of skills and experience; and soundness of judgment combined with a healthy degree of scepticism.

Collier (1992) found that the most important factors making for the effectiveness of audit committees were believed to be: sound judgment; independence from management; a full understanding of the purposes and responsibilities of the audit committee; and an enthusiastic chairman. Factors deemed to be unimportant include: technical knowledge on the part of committee members; continuity of membership; independence from the main board; and rotation of membership.

*The Netherlands*

Although there is no Dutch literature regarding the effectiveness of the audit committee per se, research by van Moerkerk (1992) indicated that an effective committee should have the following administrative features:

- regular meetings, with an agenda, minutes and chairman;
- a committee statute with a clear description of tasks and functions; and
- regular meetings held prior to the meetings of supervisory boards and the annual general meeting of shareholders.

This research also suggested that new audit committee members should be trained and that discussions should be held with the chief financial officer and auditors to help new members understand the business. The attitude of the board of management towards monitoring, controlling and auditing should also be established. In addition,
unrestricted access to internal and external auditors should be available to audit committee members (if necessary, without the attendance of management).

**The US and New Zealand**

As stated earlier, Kalbers and Fogarty (1993) examined audit committee effectiveness in terms of power. They found that formal, written authority coupled with observable support from top management play the most important roles in audit committee power as it relates to effectiveness and concluded that the organisational dimensions of power are crucial for effectiveness. Audit committees require a strong organisational mandate through a written charter and sufficient informal recognition by chief executive officers, other senior executives and other persons within the organisation. These factors highlight the importance of mechanisms for ensuring accountability among the audit committee, the external and internal auditors, and management.

Other key constituents of effectiveness identified by Kalbers and Fogarty were the expertise of committee members (primarily for dealing with the complexities of financial reporting), ‘diligence’ or ‘will’, and persistence and dedication to the fulfilment of responsibilities. The problem with the constituents is that, with the possible exception of a written charter, they are particularly difficult to measure. Kalbers and Fogarty suggested that the regulation of audit committee effectiveness might aim for substantive reviews of power within the organisation. It is a moot point whether this idea could be made operational.

This emphasis on ‘intangible’ factors was also evident in several earlier US studies, eg Mautz and Neumann (1970 and 1977), Grinaker *et al.* (1978) and Spangler and Braiotta (1990). Diligence and the personalities of audit committee members are prominent among the factors identified by these studies.

Verschoor (1994a, 1994b) has produced two monographs relevant to audit committee effectiveness, based on the history of regulation in the US, and his own consultancy experience. The issues addressed include: the operational procedures of the committee (these should be specified); its
optimum size and knowledge requirements (expertise should cover a broad range of areas, including broad business experience, industry knowledge and financial and accounting expertise); independence considerations; its oversight function as a partner with management, rather than as a policing mechanism of management; and the need for a formal written charter. Verschoor also detailed his perceptions relating to the qualities of effective audit committee members, including the level of expertise needed, time availability and personality factors.

McMullen's (1992) findings indicated that audit committees whose members have accounting or legal experience are associated with higher quality financial reporting. To an extent, this is inconsistent with the findings of Collier (1992) in the UK. DeZoort (1997) found that audit committee members appreciated the importance of all audit committee members having sufficient expertise in oversight areas related to accounting, auditing and the law, with some respondents acknowledging that they lacked sufficient expertise in these areas. Additionally, De Zoort found that audit committee members tend not to recognise their assigned responsibilities as detailed in company proxy statements.

The issue of audit committee effectiveness is addressed by The Blue Ribbon Report (NYSE/NASD, 1999). Factors emphasised by this report include: the financial literacy of audit committee members; the adoption, and annual review, of a formal written charter by audit committees; and the importance of dialogue between the audit committee and the auditors, in particular, the external auditors. The Blue Ribbon Report also recommended that audit committees report annually to shareholders on how they have satisfied their responsibilities under their charters.

In New Zealand, Porter and Gendall (1998) investigated the views of external and internal auditors, company and public sector chairpersons and financial statement users. All groups considered that the effectiveness of audit committees could be improved by: ensuring they have clearly defined written terms of reference; routinely providing all relevant parties with minutes of audit committee meetings; and disclosing the existence, membership and objectives of audit committees in corporate annual reports.
Evidence of effectiveness

Prior to Cadbury, Collier (1992) found little evidence of much attention being paid to measures of effectiveness and concluded that the evidence was generally equivocal. In the US, the evidence includes that of Jackson-Heard (1987) who concluded that audit committees enhance the independence of the external auditors but only to a limited extent. Vinten and Lee (1993) stated, based on a report in the US by Coopers and Lybrand (1988), that most audit committee work is reactive and passive rather than proactive. This may indicate that not all ways by which audit committees might operate effectively are being explored.

Sommer (1991), also writing in a US context, indicated that there was considerable anecdotal evidence that many audit committees fell short of doing what was generally perceived as constituting their duties. The problem of assessing whether or not audit committees as constituted presently are operating effectively is compounded by the difficulty of determining what precisely constitutes effectiveness.

There is also a largely US-based literature which, while it does not assess the effectiveness of audit committees per se, has suggested that the establishment of audit committees would result in an enhancement of the financial reporting process. Wild (1994; 1996) provided evidence that audit committees increase the accountability of management to shareholders by improving financial reporting quality. Beasley (1996) and Dechow et al. (1996) argued that firms which manipulate their earnings are less likely to have operational audit committees.

Lee and Stone (1997) identified an apparent mismatch between the technical nature of many areas of audit committee responsibility and the non-technical backgrounds of many audit committee members. They argued that their results call into question the potential effectiveness and independence of audit committees.
Criteria to assess effectiveness

The literature reviewed (eg Kalbers and Fogarty, 1993; Lindsell, 1992; Porter and Gendall, 1998; Verschoor, 1994a, 1994b) did not reveal the use of criteria or benchmarks to assess audit committee effectiveness. It did, however, show there to be a reasonable degree of consensus regarding factors that might be used to develop specific benchmarks. Four factors emerged as important: organisational power (including formal written authority); a broad range of expertise on the part of committee members; persistence and dedication of committee members combined with a healthy degree of scepticism; and independence of the audit committee.

The issue of developing criteria and benchmarks to measure audit committee effectiveness cannot, however, be separated from the more fundamental issue of what constitutes effectiveness. It is, therefore, unsurprising that the literature on benchmarking is relatively undeveloped given the lack of consensus on the more major issue.

Means by which audit committees assess internal and external audit quality

The assessment of the quality of audit work and, in particular, that carried out by the internal auditors, constitutes a crucial component of the work of audit committees (or FRACs, were the ICAS (1993) proposals to be implemented). In the Netherlands, The Peters Report (1997) highlighted the work of audit committees in assessing the work carried out by external and internal auditors. This establishes another dimension to the issue of assessing the effectiveness of audit committees in addition to those identified earlier, such as: functions assigned to the committees; their composition; and the time available to be spent by committee members. This section, therefore, examines how audit committees might assess audit quality.
The UK

There appear to be no UK studies that examine the question of how audit committees assess audit quality.

The Netherlands

Where a Dutch company has established an audit committee, the supervisory board is nearly always represented. In most cases, the audit committee exchanges information regularly with internal and external auditors. The representation of the supervisory board on the audit committee provides the opportunity to assess internal and external audit quality. No discussion was found in the literature about the extent to which audit committees assess internal and external audit quality. A major contribution of audit committees may be that they represent a formal constitution of the regular discussions between the supervisory board and the external auditor, with or without the presence of management. It can be questioned, however, whether a formal audit committee is the (only) proper way to institute such discussions. If the external auditor and/or the supervisory board take advantage of opportunities to meet each other at any suitable moment, this may perhaps provide a better and less cumbersome solution than formal and regulated meetings of the audit committee, held at fixed intervals.

The US

In the US, auditing standard SAS 61 Communication with Audit Committees (AICPA, 1988) deals with the relationship between external auditors and audit committees. It states that audit committees should be knowledgeable in a number of areas, including the level of assurance on financial statements provided by audit, the determination of management judgment on accounting policies and estimates, the existence of audit adjustments and the nature of disagreements between external auditors and management (Verschoor and Liotta, 1990).
Knapp (1991) carried out a survey of audit committee members’ perceptions of external audit quality. His research indicated that assessments of audit quality were significantly influenced by auditor size and by length of auditor tenure. Knapp’s study, however, did not indicate that audit committee members attributed a higher level of audit effectiveness to structured audit approaches compared to unstructured approaches. The results of Knapp’s survey may indicate that audit committees assess audit quality in an artificial and mechanical manner. It may be that this general approach would also apply to audit committees’ assessments of internal audit quality and, if so, there is a particular need to develop indicators of internal audit performance.

Comment and key issues

Our review indicates that most major UK companies have established audit committees as recommended by Cadbury and others. Consequently, there is already a useful platform for the implementation of the ICAS (1993) proposals. Many large Dutch companies have also now established audit committees.

Typical structural and operational differences between Anglo-American and Dutch audit committees are summarised in Table 3.1.

Table 3.1 Comparison of alternative audit committee models

<table>
<thead>
<tr>
<th><strong>ANGLO-AMERICAN MODEL</strong></th>
<th><strong>DUTCH MODEL</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-committee of the unitary board</td>
<td>Sub-committee of the supervisory board</td>
</tr>
<tr>
<td>Grounded in broad ethos of corporate governance</td>
<td>Viewed as existing primarily to render service to supervisory board</td>
</tr>
<tr>
<td>Regarded as key component of corporate governance</td>
<td>Regarded as less important as discrete entity</td>
</tr>
<tr>
<td>Has few members</td>
<td>Has more than five members</td>
</tr>
<tr>
<td>Two to four meetings annually</td>
<td>Two meetings annually</td>
</tr>
</tbody>
</table>
In addition to the differences identified from the literature review there was broad consensus that appropriate expertise and independence were the two principal factors of relevance when considering the composition of audit committees. Opinions differed, however, as to the relevant importance of these factors. There may, however, be problems in reconciling these different demands; eg it may be difficult to identify individuals who are sufficiently independent and characterised by a sufficient degree of financial expertise. As noted earlier, the phenomenon of 'grey area' directors appears to be significant (Vicknair et al. 1993). The issues of expertise and auditor independence also emerged from the discussion of audit committee effectiveness. Other factors to emerge as important to effectiveness were organisational power and dedication/scepticism.

**Key issues**

The key issues identified from the literature for investigation at the fieldwork stage are:

- identification of the functions and responsibilities of the audit committee;
- documentation of the background and expertise of audit committee members;
- evaluation of independence of the audit committee;
- assessment of the effectiveness of the audit committee itself;
- assessment of audit quality, particularly internal audit quality, by the audit committee; and
- identification of interactions between the audit committee and other internal monitoring bodies.

**Endnote:**

1 Appropriate expertise and independence also emerged from the literature on audit committee composition.
CHAPTER FOUR

LITERATURE REVIEW: INTERNAL AUDIT

This chapter first sets out the main ICAS proposals relating to internal audit. It then reviews the literature on internal audit, covering: history and development; functions and responsibilities; staffing; reporting mechanisms; assessment of effectiveness; and maintenance of independence. A final section offers comment and identifies key issues for investigation at the fieldwork stage.

ICAS (1993) proposals relating to internal audit

To provide a board of directors with reassurances that its management information systems and internal control systems are sufficiently reliable and relevant we believe each company should establish and maintain a strong internal audit function under the direction of a Chief Internal Auditor. We envisage an internal audit team that is significantly stronger than is typically found in UK listed companies at the present time. As the internal auditors will be carrying out their work on a continuous basis and as they should have a sound understanding of the range of activities in which a company is involved, the Chief Internal Auditor should be in a strong position to provide a board of directors with reassurances regarding the reliability and relevance of the systems being operated within that company. (ICAS, 1993, p56)

History and development

The history of internal audit in the Netherlands is different from that of internal audit in the UK and North America. This section reviews the history and development of internal audit departments in these countries.
The UK

Internal audit functions were developed across both private and public sector organisations at the beginning of the twentieth century (Sherer and Kent, 1983). This was a response to the growth, and increased complexity, of many organisations (Gupta and Ray, 1992); the demand for a satisfactory means by which managers might evaluate business operations; and the greatly increased competitive environment which UK companies began to find themselves in during the early twentieth century\(^1\). Internal auditing functions began to undertake the role of ensuring that recorded information on costs and productivity was accurate, reliable and up-to-date (Sherer and Kent, 1983).

As industrial enterprises grew significantly in size, the perception arose that entity management, rather than the external auditor, exercised the primary responsibility for the detection of fraud and error. This provided an additional role for the internal audit function. McNamee (1995) noted that advances in systems thinking and the organisational change resulting from World War II led to major changes in the practice of internal auditing. The systems approach to internal audit replaced the prior approach of detailed verification and reperformance.

UK evidence suggests that the purpose of internal audit has changed dramatically over the last fifty years and that it continues to evolve and to develop. The main landmarks of development appear to be a move from narrowly-based and defined financial audit through to systems-based audit and from there to different categories of management and operational audit (see, for example, Vinten 1991). Operational audit has been an accepted part of internal audit for a considerable period of time.

Significant developments in both internal and external audit included: an increasing emphasis by the accountancy profession on the role of internal audit in relation to internal control; the outsourcing of internal audit functions to public accountancy firms; and a major paradigm shift in the approach to external audit adopted by the accountancy profession. These developments suggest that a focus on operational audit does not represent the ultimate in internal audit development which may in the
medium term take the form of a significant degree of conflation both of financial and non-financial internal audit and of the external and internal auditing functions.

The Netherlands

In the Netherlands, internal audit originated before World War II. Again, the growth of companies forced management to delegate its tasks. To ensure that delegated management functions were performed correctly, internal audit was used to confirm that an adequate system of internal control was in place. During the pre-war period, the external auditors typically did not rely on the work of their fellow internal auditors (van Lieshout and van Zutphen, 1993), because the internal auditors did not undertake an external attestation function.

Causes of shift to operational audit

Wilschut (1976) stated that the internal auditor should focus on supporting management rather than on certifying the internal annual accounts. By the 1980s the internal audit task had changed partly from financial to operational auditing. This change was caused by: the internationalisation of the Dutch external audit profession and Dutch companies; the lack of development of international regulation, the need of management to control business activities; and developments in management information systems and accounting (van Lieshout, 1993). These developments and their impact are now described in greater detail.

External auditors attempted to persuade internal auditors to concentrate more on management information systems and accounting, including EDP audits. The reason for this was the expansive growth of external audit firms, which made it possible for external auditors to concentrate on the financial auditing of large (often international) enterprises.
Internal auditors supported the board of management in controlling international business. In particular, the internal audit functions of large international companies like Philips, Royal Dutch Airlines and Unilever took the lead in this development. As a consequence, the financial audit was assigned increasingly to the external auditor.

The attempts of Royal NlRA to give the internal attestation function a legal basis failed. The internal attestation of the financial statements by the internal auditor has not been developed in other countries. Consequently, no international experience or regulation exists concerning the attestation function. As a result, Dutch internal audit functions began to concentrate more on operational auditing, particularly in cases where Dutch companies formed part of international organisations.

Due to the increasing complexity and growth of companies, management needed to control business processes. As a consequence, the internal auditor needed to concentrate more on the way business controls were managed. There was, therefore, a need to reduce total audit costs and corporate management took the view that financial audits carried out by both internal and external auditors constituted unnecessary duplication. Accordingly, financial audits were transferred to external auditors.

The use of advanced computer applications made it less necessary to perform detailed financial audit tests. In response to these developments, some Dutch companies abolished internal audit completely and transferred the financial auditing function to external auditors. Others limited the amount of financial auditing carried out by the internal audit function and expanded the operational audit function, while other companies used internal audit to carry out operational audits to supplement the primary focus of financial audit.

*Reaction to shift*

Some Dutch authors were negative about the shift from financial to operational audits. In their view, the limitation in the functions carried out by internal audit departments limited the possibilities for internal
auditors to gain experience, thereby decreasing the quality of audits (Ekelschot, 1993). Others considered the shift to be a positive development, believing that the internal auditor could fulfill more effectively the needs of management as a result. It was argued that stakeholders expected more than just certification on the annual accounts, they wished to be sure that no fraudulent activities had occurred, that the going concern of the company was guaranteed and that management controls were adequate. Management needed to strengthen controls over business activities and business risks in response to changing stakeholder demands. In this changing environment, internal audit is potentially of greater value to management (Ekelschot, 1993); most importantly in monitoring and operating the system of ‘internal business controls’.

Paape (1995) also emphasised that internal audit should assist and support management in monitoring internal or business controls. Furthermore, he stated that financial audits focus on the presentation of the past, whereas operational audits focus on the future. The shift from financial to operational auditing is a shift from retrospective to prospective auditing. According to Paape, Royal Dutch Airlines’ internal audit has heightened its effectiveness and value to management by performing operational audits (Paape, 1993).

The influence of Philips

Although internal audit did not have an attestation function in the Netherlands in the pre-war period, the internal audit department of Philips Gloeilampenfabrieken N.V. in Eindhoven was an exception and issued an audit report on the internal financial statements (Vecht, 1989). In 1939, Goudeket, Philip’s chief internal auditor, stated that the distinction between internal and external auditors was merely formal (Goudeket, 1939). According to Goudeket, internal auditors should be a member of the same professional organisation as external auditors because their assignments did not differ. This opinion met resistance, for instance, by Professor Limperg, who argued that since the internal auditor was an employee, he was not a reliable auditor (Limperg, 1965).
After World War II, based on the success of Philips' internal audit, Goudeket made the internal audit function technically equal to the external audit function. Internal and external auditors received the same education and became members of the same professional body. As a result, it became generally accepted that internal auditors attested the internal annual accounts and that external auditors relied on their results. According to NIVRA, the statement of the internal auditor was only to be used for internal purposes (Goudeket, 1956).

In 1956, Goudeket modified his earlier position and commented that the distinction between internal and external auditors was not formal but functional (Goudeket, 1956). Internal auditors received their assignment from company management whereas external auditors received their assignment from external stakeholders. Goudeket considered internal audit to be a function derived from management. As a consequence, the internal auditor should be accountable only to the board of management. In this way, it would be able to perform its duties adequately and to guarantee its independence.

Goudeket also stated that the internal auditor might exercise an advisory function; this is consistent with the view that the internal auditor was primarily responsible to management. Due to their expertise, the internal auditors would be consulted by management on many occasions. In addition, Goudeket argued that the internal auditors would also be able to exercise unbiased judgment because of their position within the organisation. The view was expressed that not only was the internal audit function a sounding board for management, but also it was independent of all but the highest levels of corporate management. He also argued that the internal auditor has specific industry knowledge, which could, however, coexist with a lack of the wide experience needed to act as an effective consultant.

In the 1960s, Dutch retail and industrial companies expanded rapidly and many more internal audit departments were founded. The growth of public enterprises also contributed to the increasing number of internal audit departments. In 1968, Louwers, Goudeket's successor in Philips, stated that the hierarchical position of internal audit together with its attitude determined the effective functioning of the department (Louwers, 1968). Additionally, he stated that, with the exception of information
required for circulation to the board of management, the internal auditor should report to the highest level in the company in situations where reporting to lower level management did not lead to the required action.

Louwers believed that the internal auditor could undertake an advisory function, but not in the way suggested by Goudeket (1956). Louwers considered the internal auditor to be a co-ordinator of the various highly qualified experts that a company might consult. The internal auditor should have a general view of the company and should be able to determine when it was necessary to consult an external expert. From 1984, Philips' internal audit department no longer carried out financial audits to reduce internal audit costs (Zeff et al. 1992) and this confirmed, to an extent, its development into a more management/operational auditing orientated role.

Functions and responsibilities

*Auditing into the Twenty-first Century* challenged the present role of internal audit in the UK. A similar challenge came from *The Cadbury Report* (1992), which suggested that it would be good practice for companies to establish internal audit to undertake regular monitoring of key controls and procedures. In addition, it was suggested that internal audit would be well placed to undertake investigations on behalf of audit committees and to follow up suspicions of fraud.

Accordingly, this section considers the various definitions of internal auditing found in different countries and the different types of internal audit.

Definition of internal auditing

The definitions used in the UK, the Netherlands and the US are given and compared here.
The UK

In SAS 500 *Considering the work of internal audit* (APB, 1995) the APB defines internal audit as 'an appraisal or monitoring activity established by management and the directors for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems'.

The Netherlands

Traditionally, the function of internal audit has concentrated on financial auditing and this is defined as 'the audit resulting in a statement on the internal annual accounts' (Breedveld-Krans, 1991). It is suggested that internal auditors are ideally placed to perform these functions because of their professional skills and their knowledge of the organisation (NIVRA, 1993). According to NIVRA, the statement of the internal auditor is only to be used for internal purposes (NIVRA, 1993). As a consequence, the internal auditor is required to state in writing that the auditors' opinion is only to be used by their employer and therefore should not be given to third parties (NIVRA, 1998).

The US

The US-based Institute of Internal Auditors in its *Statement of responsibilities of internal auditing* (1981) stated that 'internal auditing is an independent appraisal activity established within an organisation as a service to the organisation. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls'. In the same document, the scope of internal auditing is stated to encompass 'the examination and evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of performance in carrying out assigned responsibilities'. This definition also applies within a UK setting.
Types of internal auditing

A useful, though dated, review of the different types of internal audit is given by Vinten (1985) who categorised the internal audit role into financial, systems, management and social. The first two are inter-related and an alternative classification might envisage systems audit as purely one component of financial audit. Vinten, however, saw financial audit as more narrowly defined and in terms primarily of a verification audit, although he did make it clear that the internal auditor may have wider objectives than merely the ‘true and fair’ certification of accounts. Similarly, systems audit, to the internal auditor, may embrace more than solely financial based systems. The critical distinction between management audit (also known as value for money audit), Vinten’s third category, and both financial and systems audits, lies in the management audit’s grounding in the ‘3Es’ concepts of economy, efficiency and effectiveness. Management audit is also distinctive in its forward-looking orientation and in its use of both financial and operational data. Management audit may also be termed operational auditing, strategic auditing, economy and effectiveness auditing, or value for money auditing. Social audit would appear to remain virgin territory for most internal audit departments and inevitably involve problems of politics, subjectivities and conflicting values.

Van Lieshout (1994) distinguished between two forms of operational audit, which have a limited and extended scope, respectively. Operational audit of limited scope focuses on the accounting system and internal controls as part of a systems-based financial audit. Operational audit of extended scope is the auditing of all internal business controls, including internal accounting controls. (Van Lieshout, 1993).

The UK

The overlapping areas of operational audit, internal control evaluation and risk management are considered in turn.
Operational audit

Increasingly, the internal audit role involves an examination of the overall performance of an enterprise including that of enterprise management. Value for money auditing, has assumed the primary position in many internal auditing functions. Initially, value for money auditing evolved within the public sector but the techniques have since become familiar in many private sector organisations. Many internal auditing functions no longer see their primary mission in terms of traditional financial auditing. Contemporary data on the extent of competing internal auditing rationales was highlighted at a conference on the future of internal auditing sponsored by KPMG (KPMG, 1994). On average, participating organisations reported that 30% of their audit activity was devoted to financial audits, 50% to operational auditing, and the remaining 20% to various kinds of ad hoc reviews.

In a series of UK symposia for internal auditors it was noted that internal auditors, because of pressures on costs, were being asked to place more emphasis on internal consulting, and become a source of ideas for reducing cost and increasing profit (Arthur Andersen, 1994). The general impression is of an ever-increasing emphasis on providing business solutions and on an enterprise culture within internal audit. It was also noted that the anticipated trends in internal audit work towards the year 2000 indicated a growth in consultancy work at the expense of compliance, together with a greater emphasis on non-financial areas. The symposia raised the issue of how audit committees would be able to obtain the increased assurance necessary if a declining proportion of audit time was spent on compliance work in financial areas.

Internal control evaluation

The Audit Agenda (APB, 1994) envisaged an increase in importance of internal audit as a result of the need for vigilance in control systems aimed at fraud minimisation (which may include forensic auditing) and the need to ensure integrity of management information. The Hampel Report (Hampel, 1998) and The Turnbull Report (ICAEW, 1999) both emphasised the importance of internal audit in relation to the maintenance
of such systems of internal control. Additionally, both reports envisage internal control to encapsulate more than merely the financial. This suggests that there will continue to be an important financial audit role for internal audit, but that this may increasingly embrace areas of work that have traditionally been regarded as outwith the province of the financial auditor. Professional thinking has also suggested that high profile internal audit should be responsible for covering the whole system of internal controls in public interest companies (Perrin, 1997).

The Audit Agenda has suggested that work is required to establish appropriate standards and guidance and to consider what reliance the external auditor should place on the work of internal audit to achieve the best cost/benefit balance (APB, 1994). The APB also observed that the growing real-time nature of data holds the potential for real-time audit and may necessitate further changes to internal audit functions.

Risk management

Bruce (1997a) is among those who have suggested that internal audit will become increasingly involved with risk assessment and management. In addition, he argued that modern internal audit can add substantially to the means by which companies seek to ensure good corporate governance. The results of a survey undertaken by the ICAEW (1996) indicated that 84% of internal audit time was spent on work covering the following areas: operations and business processes (30%), financial audit (24%), IT systems audit (13%), special investigations (10%) and work related to regulatory compliance (7%). Risk management and the review of projects and operations were shown to be of increasing importance and it was recommended specifically that internal audit should include these areas within their scope of work. The importance of risk management to the work of the internal auditor has been reinforced by the issue of a briefing note on the subject by the IIA (1998) which presented the view that there is a need for internal auditors to become expert advisers in risk and control. The IIA publication noted that the closer involvement with management which may be implied by this change in focus has implications for audit independence.
The importance of risk management for the work of the internal auditor has also been emphasised by The Turnbull Report which argues that 'the main role of internal audit is normally to evaluate risk ...' (ICAEW, 1999). This, however, is disputed by Wynne (1999) who argued that internal audit is not risk management and that internal auditors are concerned with the review of the extent to which managers and board members have identified, evaluated and managed the companies' risks and the monitoring of the system of internal control which has been introduced to address significant risks. Wynne argued that the evaluation of risk is a key management task and a subjective assessment that should not be delegated to business advisors.

A survey of the internal audit functions of a sample of FTSE 350 companies has been undertaken by Arthur Andersen (Reast, 1998). The survey indicated continued growth in the number of companies with internal audit functions and also that internal auditors were increasingly involved in an ongoing partnership with management. The survey highlighted that the management of risk was taking place on a more proactive basis than hitherto and indicated that it was becoming the norm for internal auditors to act as an agent for change. Overall, around 25% of all responses highlighted the opportunity for internal auditors to provide risk management consultancy. The survey predicted significant growth in this area as well as those of management and IT systems work².

McCuaig (1998) argued that assurance as opposed to auditing per se will become of increasing importance to the internal auditor and highlighted control self assessment as a key theme within this new assurance-focused environment. Traditional auditing and control self assessment differ in that in a traditional audit, the auditor makes the risk assessment decision whereas in control self assessment, management and work groups make the decision. The auditor's job is instead to determine whether or not the conclusion reached is sound, based on information about the existing levels of control and risk and based on predetermined criteria. McCuaig noted that within the contemporary business environment assurance may be required on a wide variety of issues including such diverse areas as customer service, regulatory compliance
and external disclosure reliability. Contemporary evidence and developments in current thinking on internal audit suggest that the professional scope of internal audit will continue to widen.

The Netherlands

Internal audit performs a combination of roles with some evidence suggesting that internal audit functions have undertaken more operational audits than financial audits. It has been suggested that internal auditors are 'partners in business', while external auditors are responsible for financial auditing (Driessen et al. 1993). In addition, it has been suggested that internal audit could operate in an internal consultancy role advising management on how to improve the deficiencies in internal controls identified during the financial audit and also advising on matters concerning mergers, investments and internal organisation etc. Other internal audit functions have been identified as electronic data-processing audits, management-orientated audits and the undertaking of special assignments (NIVRA 1993). According to van Lieshout, internal audit which focused previously only on financial audits are now performing operational audits in the limited sense. Ekelschot (1993), however, suggested that whilst internal auditors spend more time on operational audits, they are still involved in financial audits although this does not necessarily lead to the formal certification of the internal financial statements.

Worldwide

One significant international development deserves mention. There is increasing evidence of a major paradigm shift in the approach to external audit adopted by the international accountancy firms. This theme is the subject of an article by Jeppeson (1998) who focused specifically on the firm of KPMG. An important feature of this paradigm shift is an increasingly consultancy and business-orientated audit focus to the extent that, arguably audit as an independent concept no longer exists. In one sense, this might be interpreted as an internalisation of external audit.
The implication is that the distinction between external and internal audit is likely to become increasingly less important in the future. Given other developments such as the increasing emphasis by the accountancy profession on the role of internal audit in relation to the assessment of internal control and the outsourcing of many internal audit functions, there may eventually be virtually no distinction between external and internal audit.

**Staffing**

This section considers the staffing practices within internal audit in the UK and the Netherlands and considers, in particular, the impact of outsourcing trends in the UK and North America.

**The UK**

Traditionally, internal audit has been staffed by accountants. Arthur Andersen (1994), however, forecast that by the year 2000 internal audit would no longer be closely allied to the finance function and that very few functions would be staffed predominantly by accountants. In a large number of functions, accountants would be in the minority because staff from other disciplines would be necessary to provide the expertise required to deal with all areas of management including operations, systems and strategic planning. This trend has been in evidence for some time. A series of surveys carried out in the UK and Eire for the IIA showed that the recruitment of employees from disciplines other than accountancy was occurring in a large number of organisations. (IIA, 1976; 1986).

The changing composition of internal audit reflects the changing scope of internal audit discussed earlier and the changed competences on the part of the internal auditor which are required as a result of this. A survey of internal audit of the top 200 FTSE companies found that 55% of internal audit staff had a financial or internal audit background, 14% had commercial and IT backgrounds, 9% had a general management background and 7% had other backgrounds (Gascoyne, 1998).
Outsourcing

A recent development with a major impact on staffing is outsourcing. On the supply side, the international accountancy firms have recognised that internal audit has the potential to generate significant revenue growth. On the demand side, companies recognise that a much wider range of skills is required to be covered by the modern internal audit function than hitherto. These companies are, therefore, deciding to concentrate on their core business rather than on peripheral activities. Outsourcing does not always result in the complete elimination of an organisation’s internal audit function and a core staff may be retained to work in partnership with the external contractor.

Outsourcing in the UK is relatively new and was almost unheard of before the 1990s. The internal audit function, in whole or in part, has now been outsourced in a variety of organisations within both the public and private sectors. Maddocks (1998) investigated the scope of outsourcing in a survey of 500 diverse organisations from both the private and public sectors. Ninety-two percent of respondents had some sort of internal audit function and, of these, only 39% had service provided totally by an external organisation, while 52% of outsourced services were provided by the five largest accountancy firms.

The implications of outsourcing for the implementation of the ICAS proposals are unclear. There is evidence that some outsourced internal audit is provided by the same firms that provide external audit services. This, however, would go against the spirit of the ICAS proposals in terms of the implications for the independence of both internal and external audit services. Another possible implication, however, may be more rigorous quality control of internal audit as a result of the importation of a litigation-driven public accountancy firm culture of quality control.

The Netherlands

The Dutch situation is different because the proportion of accountants employed in internal audit is much smaller. Research in 1986 indicated that approximately 22% of the total staff of 27 internal audit departments
were chartered accountants (Dekker and Langendijk, 1986). This had fallen to 17% by 1991 (Breedveld-Krans, 1991) but had recovered to just over 22% by 1995 (Snel). It has been argued that this evidence confirms that the best education for an internal auditor is that for a chartered accountant (Ekelschot, 1993). Additionally, it has been suggested that an internal auditor should be educated in fields such as electronic data-processing, auditing, business administration and operational audit. These suggestions, however, may need to be reviewed as a result of the shift from financial to operational audit and the requirement for a different skill base of staff.

According to Paape, former chief of operational audit of Royal Dutch Airlines, internal audit focusing on operational auditing should no longer hire only auditors or accountants (Paape, 1993), but should attract experienced managers. Similarly, the chief internal auditor at Shell, has stated that internal audit should be managed by a trained and experienced manager (Tijthoff, 1993). Arguably, a trained manager can communicate on the same level with management, and bring ‘control issues’ to their attention more easily. It may also be argued that trained managers are in a better position to maintain their independence.

North America

In North America, outsourcing has a longer history than in the UK. For instance, in Canada 35% of central government internal audit was outsourced in 1986 (Office of the Comptroller General, Government of Canada, 1986). KPMG (1996) surveyed 2000 US corporations, each of which had over 1,000 employees, and found that 40% thought that there was value to be obtained from the outsourcing of internal audit. Rittenberg and Covaleski (1998) carried out a series of interviews with corporate organisations and the external providers of internal audit services. They concluded that the size of the internal audit market was at least 250% of the existing external audit market. The potential for the future growth of outsourcing is enormous. International accountancy firms are the major players in the outsourcing market. A survey carried out for the IIA in North America identified that the ‘Big Five’ accountancy firms provided around 60% of the internal audit work outsourced in
North America (Kusel et al., 1996). Three main reasons for the current popularity of outsourcing were identified: the provision of budget savings; access to skills which were currently not provided by existing internal audit staff; and the success of the large accountancy firms in selling the idea that externally provided internal audit was a superior product to the traditional version.

**Reporting mechanisms**

This section considers the reporting mechanisms for internal audit in the UK and the Netherlands.

**The UK**

Over twenty years ago, the IIA (1978) provided some general guidance in the area of reporting mechanisms:

*The chief internal auditor should be responsible to an individual in the organisation with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.*

The chief internal auditor should also ‘have direct communication with the Board’. The IIA, in a separate statement, deals with the relationship of the internal audit function to the audit committee. While the statement does not require that internal audit reports routinely to the audit committee, it is stated that the audit committee should review annually internal audit’s objectives and goals. It is also stated that ‘the director of internal auditing should inform the audit committee of the results of audits, highlighting significant auditing findings and recommendations’.

More recently, SAS 500 *Considering the work of internal audit* (APB, 1995) suggested that in an ideal situation, internal audit would report to the highest level of management but also have a direct line of communication to the entity’s main board or audit committee. Internal audit would also be
According to De Jaeger (1995) the independent position of internal audit will be strengthened when internal audit reports directly to the audit committee. This assumption is confirmed by van Moerkerk’s empirical work (1992) which found that most internal auditors believed that reporting to the audit committee and supervisory board would enhance the independence of the internal and external auditor. A slightly lower percentage stated that reporting by internal audit to the board of management influences positively the independence of the external auditor.

Assessment of effectiveness

The assessment of internal audit effectiveness in the UK and the Netherlands is considered.

The UK

If much of the work carried out presently by external audit is to be shifted to internal audit as proposed by ICAS (1993), then quality control issues become paramount. The external auditor can rely on the work of the internal audit department only where the quality of internal audit is satisfactory. Standard 560 Quality Assurance of the Standards for the Professional Practice of Internal Auditing already requires the chief internal auditor to establish and maintain a quality assurance programme to evaluate the operations of the internal audit function (Chambers et al., 1987). Also of relevance in the UK is SAS 500 Considering the work of internal audit (APB), which gives guidance to external auditors wishing to rely on internal audit. It suggests that the important criteria for performing an assessment of the internal audit function are:

- **organisational status** - in particular, internal audit’s specific status in the organisation and the effect this has on its ability to be objective;
- **scope of function** - the nature and extent of the assignments which internal audit performs; external auditors also to consider whether management and the directors act on internal audit recommendations and how this is evidenced;
- Technical competence – whether internal audit work is performed by persons having adequate technical training and proficiency as internal auditors; and
- Due professional care – whether internal audit work is properly planned, supervised, reviewed and documented.

The IIA’s Standard on Quality Assurance (IIA, 1998) suggests that a quality assurance review programme should include supervision, internal reviews, and external reviews. The issue of quality control was examined by Ratcliffe et al. (1993), who identified a wide range of quality control techniques used to assess external audit, which might be used to assess internal audit. These procedures are largely predictable and routine and include workpaper review, independent executive review, standard workpaper formats and performance review summaries. Ratcliffe et al. indicated that more techniques are used to assess external audit than to assess internal audit, suggesting that external audits are supervised more closely. They also indicated that greater variability exists in the number of techniques used to assess internal audit. Major supervision techniques common to both include audit team meetings, written audit programmes and workpaper review.

Hopkins (1995 and 1997) undertook research on perceptions of internal audit quality within the UK public sector. This concluded that there were significant differences between auditors’ and auditees’ perceptions of audit quality and that these differences were likely to affect the probability of internal audit services’ success in a competitive environment. Hopkins found that the majority of auditees attached a high priority to being involved more with the audit process and of working more closely with their auditors. While this research was undertaken within a public sector environment, and is therefore not directly relevant to this project, it does demonstrate the difficulty of arriving at a consensus regarding what constitutes ‘good’ internal auditing.

It may be that problems of ensuring a comparable standard of quality control between internal and external audit will be difficult to resolve due to the lack of external constraints on internal audit quality. It is accepted that the existence of rigorous quality control procedures in
external audit is due, at least in part, to the pressure of potential litigation. Improved procedures to ensure quality control in internal audit may, therefore, be necessary. The outsourcing of internal audit may have implications for this issue since where internal audit is outsourced the (arguably) more rigorous quality control procedures of external audit are likely to apply. The question of the comparative assessment of internal audit quality by external auditors versus internal auditors is also relevant. Lampe and Sutton (1994) found that when considering internal audit quality there was a high degree of similarity between the factors considered important by internal auditors and those highlighted in the UK (external) auditing standard SAS 500 Considering the work of internal audit (APB, 1995). There were, however, some differences. Factors recognised as critical by internal auditors but not recognised in SAS 500 included, for example, corporate political pressures, sensitivity of audit findings and the level of internal audit manager involvement with the on-site internal audit team.

The Netherlands

The four important assessment criteria listed in the UK SAS 500 are also stated in the Dutch Standards on Auditing (NIvRA, 1998).

In the Netherlands, effective co-operation between external and internal auditors is made easier because all are members of the same professional body (NIvRA) and are required to perform their work in accordance with the same rules of conduct and professional standards. The following requirements of the Dutch Standards on Auditing are applicable to both external and internal audit:

- technical standards for investigations (eg audit programs);
- regulations re documentation;
- availability of reporting standards;
- internal quality control (audit plans, technical standards, reporting);
- internal (permanent) training;
- level of expertise in terms of education, organisation knowledge and experience; and
• membership of professional organisation.

**Maintenance of independence**

Both Cadbury and *Auditing into the Twenty-first Century* suggested a potentially stronger independent position for internal audit than is generally the case presently. In view of this, it is interesting to look at the current situation in the UK and the Netherlands.

**The UK**

The IIA (1981) stated that ‘Internal auditors should be independent of the activities they audit. Internal auditors are independent when they can carry out their work freely and objectively. Independence enables internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organisational status and objectivity’.

Cadbury (1992) stated that it was essential that chief internal auditors should have unrestricted access to the chairman of the audit committee to ensure the independence of their position.

It is generally accepted in the literature that the internal auditor should be independent of functional management. Bruce (1997b), however, made the point that the extent to which the internal auditors’ view will prevail within a company is dependent on internal politics, culture and personalities.

**The Netherlands**

Similarly, in the Netherlands, it has been argued that internal audit should be completely independent of management to perform its tasks adequately. As elsewhere, it has been argued that independence consists, in essence, in a mental attitude (Goudeket, 1956). The Commission which evaluated the Dutch Rules of Conduct (Commissie Inventarisatie GBR.) in 1993 stated that auditors were independent in *appearance*. Van Wessem, however, stated in 1988 at the Annual Congress of Accountants that ‘... it
is not the independence in relation to the principal but the fact that the auditor is independent in his opinion about the acting of the principal which was important.

Independence in fact is related, amongst other things, to the hierarchical position of internal audit within the organisation. In this respect, internal audit ought to be located independently of functional management and the chief internal auditor ought to report directly to the chief executive officer. Dutch internal audit generally has a hierarchical position directly beneath the board of management. Independence can also be strengthened through written commitment by the board of management, regarding the required competence of internal audit, open communication with the external auditor and access to all information, and the appointment of the chief internal auditor by the audit committee or supervisory board (van Moerkerk, 1992).

Sometimes practice diverges from theory and Tijthoff (1993) described the situation in Shell where commonly internal audit is located within a financial division. In this company, the chief internal auditor is a member of the internal audit committee in order to strengthen independence.

Dutch standards on auditing (NIvRA, 1998) state explicitly that in cases where the auditor combines consultancy and financial auditing, the judgmental process leading to an auditors' opinion should be impartial. Paape (1995) referred to the research of Church & Schneider (1991), and practical experience within Royal Dutch Airlines, when he expressed the view that the so-called collusion risk is 'dead'. Internal auditors appear to place a high value on independence on audits other than those of a conventional financial nature. For instance, 23 out of 33 internal auditors who participated in the study by van Moerkerk (1992) expressed the view that independence should not be restricted to financial audits but was also appropriate to operational and management audits.

Intuitively, external auditors may be thought of as more independent than their internal counterparts. According to Wisse (in Schoonderbeek and de Hen, 1995), however, no major differences could be identified between the independence of external and internal auditors. Emanuels (in van Almelo, 1995) argued, based on empirical research, that external auditors did not have an exceptional ethical consciousness.
Comment and key issues

The dominant feature of the present functions and responsibilities of internal audit is possibly the relative lack of emphasis on financial audit compared with the growing emphasis on operational audit and the 'added value' which the internal audit function can provide to company operations. Indeed, due to outsourcing, some internal audit functions now focus exclusively on operational audit. Ultimately, it is possible that outsourcing could result in the externalisation of all internal audit services in the case of some companies. This new environment suggests that the ICAS (1993) proposals, which emphasise financial audit, may need to be presented within the added value framework in order to gain acceptance, or enthusiasm, from commerce and industry.

Of particular interest in relation to effectiveness is the strength of professional status enjoyed by internal auditors in the Netherlands where they are members of NIVRA and are required to perform their work in accordance with the same rules of professional conduct and professional standards as external auditors.

Independence is a controversial issue. The internal auditor who is employed by a company can never appear the equal in independence of the external auditor. The independence of internal audit from functional management is accepted in both the UK and the Netherlands. The literature indicates that Dutch internal audit occupies, at least in some instances, a hierarchical position directly beneath the board of management. We were particularly interested to note that in the Netherlands the chief internal auditor is in most cases a member of the audit committee.

Independence and reporting are closely linked. UK guidance documents encourage communication from the chief internal auditor to the main board or the audit committee. The Dutch pattern, however, embraces most of the UK reporting aspects and adds a role for the internal auditor in certifying the internal annual accounts. Reporting to the audit committee seems less well defined in the Netherlands than in the UK, perhaps because Dutch audit committees commonly include the chief internal auditor.
Current thinking within the accountancy profession on the future focus of external audit may hold implications for the issues explored in this chapter, as well as for the themes of this project more generally. A US report by a committee of the AICPA (AICPA, 1996) forecasts a fundamental change in auditing over the next decade. It is envisaged that the focus of the audit will change to 'a set of real-time financial and non-financial information accompanied by continuous assurance to clients and possibly to the public' (emphasis added).

These possible changes to external audit are likely to be accompanied by a continued targeting of internal audit as an area for expansion by accountancy firms and by an increase in the outsourcing of corporate internal audit functions to the accountancy profession. Future implications may include a gradual merging of the emphases of external and internal audit as both incorporate business-oriented services such as risk assessment. It is not inconceivable that, eventually, the distinction between external and internal audit may disappear entirely. The historical emphasis on independence as an indicator of external and internal audit quality, which is reflected in this chapter, may receive less emphasis in the future. It is interesting that the AICPA (1996) suggests public assurance only as a possible output of the future audit. In a UK context, contemporary evidence from the business press (e.g. Ashton, 1998) suggests similar lines of development.

Key issues

In summary, the key issues identified from the literature for investigation at the fieldwork stage of the project are:

- the changing balance between operational and financial audit and the arguments which would support an expansion of financial audit without detracting from operational aspects;
- the continuously widening scope of the internal audit role;
- measurement of the effectiveness of internal audit;
enhancement of the independence of internal audit to a point where it could be seen as sufficient to take over some part of the external financial audit role;

provision of reporting mechanisms which would ensure that internal audit could communicate directly and effectively with the board of directors and the audit committee;

existence of additional communication, other than formal reporting mechanisms, between internal audit and other internal bodies; and

the relevance of contemporary changes to the focus of external audit and of the outsourcing of internal audit to accountancy firms.

Endnotes:

1 This was due to the industrialisation of other nations and in particular, the US, Japan and Germany.

2 Other areas which were predicted to become integrated into the internal audit role included those of environmental and ethical audits.
CHAPTER FIVE

LITERATURE REVIEW:
SUPERVISORY BOARDS IN THE NETHERLANDS

This chapter provides an overview of the supervisory board in the Netherlands, reviewing the literature in relation to: history and development; functions and responsibilities; composition; time spent; and assessment of effectiveness. As supervisory boards do not exist in the UK there is no comparable literature. A final section offers comment and identifies key issues for identification at the fieldwork stage.

History and development

As a result of developments within the European Community and the report of the Commission of Verdam, the law on the structure of corporations was implemented in 1971. This has been incorporated in the Dutch Civil Code and stipulates the position of the supervisory board and its relationship with the external auditor.

A supervisory board, however, is not a requirement for all corporations; only designated large corporations have the legal obligation to establish such a board. Ordinary corporations have the option of establishing a supervisory board, although this generally has limited power and duties compared to the supervisory board of a large corporation. While it is possible to provide the board of an ordinary corporation with the specific powers and duties of the board of a large corporation this is seldom done (de Mare 1993).
Designated 'large' corporations

Large corporations are required to implement a supervisory board. In this context, 'large' means corporations with an equity of at least NLG 25 million (GBP 10 million), one hundred employees or more, and a works council. In these corporations the supervisory board has specific legal powers and authorities that supplement or override the rules for normal, ordinary corporations. The special powers are:

- to elect, suspend and remove all managing directors;
- to adopt the annual accounts;
- to (dis)approve certain specific actions of the management (in specific cases, the management needs prior approval of the supervisory board, eg the issue of shares and bonds, long term co-operation with other corporations and important changes in labour contracts); and
- to fill its own vacancies (co-option)\(^1\).

These powers and authorities mean that the supervisory board is not only an advisory body, but is actively supervisory although without executive power.

Ordinary corporations

The normal supervisory board of an ordinary corporation, when it exists, has the role and function as mentioned in article 140 BW (Dutch Civil Code): to supervise the policy of the management and the general affairs of the corporation and to advise the management in all respects. Although these general rules may be supplemented by specific rules to some extent, the managers and shareholders of ordinary corporations may not wish to give too much power to a supervisory board. They tend to use the board only to advise on medium-term and long-term decisions (De Mare, 1993; Bletz, 1994). Generally, the supervisory board can be considered to be a sounding board for management. In particular, its role is important in times of change: during a corporation's development stage; periods of rapid growth; or mergers and acquisitions. The supervisory
board in the ordinary corporation has only an advisory role. Accordingly, the remaining sections of this chapter concentrate on the supervisory board in large corporations.

Actual and proposed changes to the operation of the supervisory board

The contemporary debate on corporate governance has reached the Netherlands. Economic and social developments have resulted in changes in the role and function of the supervisory board. The board has received more power and authority, and is expected to play a more dominant role. The supervisory board is now not only a passive adviser but also an active participant, although not taking over the executive role and function of management (Boot, 1994a).

This more active attitude can be seen in a variety of different areas. First, quality has become an important criterion in the election of members of the board of management. Second, the quality of the organisation and planning have become major objectives of the supervisory board. A related objective is to optimise the extent and quality of the information provided by management. Third, the supervisory board requires to be in continuous contact with other bodies and individuals such as the works council and middle management. Furthermore, the agenda of the supervisory board has to be in line with the corporate information and planning cycle: in spring the annual accounts; in summer general policy; in autumn the latest estimate of year end. Finally, the possibility to act at any moment in time has been created (Delfos-Roy, 1992; Schaap, 1991; Kuin and van de Vaart, 1991; and de Jong and Snellenberg, 1992).

Besides this optimisation of the actual functions of the supervisory board, some authors have also recommended that both the composition of the supervisory board and its role in corporate governance should be amended. According to this view, the presence and influence of shareholders, creditors and employees should be increased. They should have a more active role in the election of board members than at present. Boot (1995) proposed the establishment of a special committee elected by shareholders, employees and other stakeholders to appoint members
of the supervisory board. He proposed that the committee should unanimously submit candidates for 60% of the supervisory board membership. These board members will be more or less representative of the different stakeholders. The other 40% could be elected by co-option and in this way these groups of independent persons, in addition to experts who may not fulfill all the independence criteria, may be represented on the board. They may then take, as Boot stated, 'their position' in the interest of the entire company (Boot, 1995).

These suggested modifications may mean that the Dutch supervisory board may develop along the lines of the American and German systems of corporate governance, without losing the formal distinction between the supervisory board and management which is inherent in the two-tier system (Boot, 1994a).

The independent position of the supervisory board is very important. Members of the supervisory board should be as free as possible of any interest group since their remit, underpinned by Dutch law, is to act in the interest of the company as a whole. The Peters Report (Peters Committee, 1997) has made various recommendations to enhance the effectiveness of the supervisory board. An underlying assumption of The Peters Report is that the co-option system supports the independence of supervisory board members.

The recommendations of The Peters Report focused on the profile, nomination and remuneration of the supervisory board, its relationship to the executive board and its activities and accountability. While the report proclaimed the virtues of self-regulation, the ministry of economic affairs has already stated that non-compliance with the report’s recommendations would lead to further regulation by the legislature.

**Functions and responsibilities**

The functions and responsibilities of the supervisory board are laid down in the Dutch Civil Code. The supervisory board’s ultimate goal is to benefit the corporation as a whole. The primary function and responsibility is to supervise the policy of management and the general course of corporate affairs. This includes intervening and, if necessary,
taking corrective action if that is in the company's best interests. The board also has the right to take the initiative to advise management on any subject it considers appropriate. Other functions and responsibilities of the supervisory board include (as outlined earlier) electing and removing management, adopting the annual accounts, prior approval of important decisions and electing its own members. In the case of conflict of interest between the corporation as a whole and individual members of the board of management, the supervisory board acquires executive power.

To fulfil its responsibility in an increasingly litigious society, De Mare (1993) suggested that the supervisory board pays growing attention to: the quality of management; the quality of planning and control cycles and techniques; contacts with other monitoring bodies; balancing the interests of different stakeholders; and specific information required for the adequate functioning of the board itself.

The supervisory board is independent of shareholders and management as members of the board are not employees of the company and their remuneration is determined by the shareholders.

Rights and duties

The supervisory board has unrestricted access to the corporate premises, and the right to inspect the books and records. Each supervisory director must sign the annual accounts. The reason for any missing signature must be stated and is (since the accounts are open for public inspection) an important external signal. Each individual board member has access to the shareholders' meetings, and may address the meeting to state their personal opinion on matters on the agenda. Finally, where the shareholders' meeting fails to appoint an external auditor, the supervisory board has the authority to do so.

Personal liability

The financial collapse of several corporations in the Netherlands and some abuse of the corporate form, led to the introduction in the early 1980's of extended personal liability for supervisory directors of a
company. The board of management and supervisory board members can be personally liable in cases of mismanagement, the issuing of misleading annual accounts, bankruptcy and the non-payment of taxes. This increased liability is not limited to the Netherlands, but is also evident in the US, UK and other European countries (Glasz 1982, Glasz 1986; Noordraven 1990; Eykman 1986; Frielink 1986; and Glasz 1995). Generally, however, this liability risk is insurable.

Composition

Under Dutch Civil Code, a supervisory board must consist of individuals, it is not permitted to include corporate members on the board. The members may be Dutch or foreign, resident or non-resident (Scholten, 1988). The total number of members is limited by the articles of association or by a shareholders’ resolution. A large corporation must have at least three supervisory board members. In principle, all members of the supervisory board have equal powers and duties. It is, however, possible to appoint a designated member who represents the supervisory board between meetings, and supports and advises the management in its day-to-day decisions.

Election, composition and suspension

Members of the board are elected by the other board members (by means of co-option). The upper legal age limit for membership is 72 years old. The procedure for appointment is as follows. The vacancy is reported to the board of management, the annual general meeting of shareholders and the works council. After receiving nominations for candidates and considering these, the board informs the works council and shareholders of the candidate(s) it intends to elect. These bodies have the right to propose candidates of their own. In cases where they believe the candidate is unqualified, shareholders and council have the right of veto. If the board insists upon its choice, the veto may be submitted to the Enterprise Chamber of the Amsterdam Court of Appeal6. This system is also known as ‘controlled co-option’.
There is little data regarding the actual composition of supervisory boards, although indications can be found in the financial press and from the position taken by the works council. For example, if there is opposition to the choice of the supervisory board to fill a vacancy, it is often made by the works council. A common objection is that the proposed candidate has too little knowledge of the rights and needs of the employees of the corporation. Works councils like at least one 'employee minded' member on the board (Wertheimer, 1975; van Luijk, 1980).

A common criticism in the financial press is that the circle of candidates from which board members are selected is very small. Some well-known persons collect memberships of supervisory boards after retirement and may be board members of ten or more different corporations. The system of co-option creates a tight and exclusive 'old boys network'.

A member of the board can only be suspended by the board itself or by the Enterprise Chamber as a result of a formal request by the supervisory board, shareholders or works council. The grounds for such a petition can only be a neglect of duties or other such serious reason, or a drastic change of circumstances as a result of which the corporation can no longer keep the board member in office.

Time spent

Membership of a supervisory board is onerous and members need to have sufficient time and interest to fulfill their function properly. There is the question of whether it is possible for a person to be a member of too many supervisory boards. In this respect, the Dutch NCD (Nederlands Centrum van Directeuren en Commissarissen), an organisation to advise directors and members of supervisory boards, advised limiting the number of supervisory boards of which one can be a member to ten. Additionally, it was recommended that the duration of membership should be limited to three periods of four years each (Bletz, 1995; Glasz, 1995). The Peters Report (1997) also advocated that the number of supervisory board memberships which one person can hold should be limited in such a way as to guarantee proper performance of duties.
No information is available about the actual time spent by members of supervisory boards. Time spent will vary depending upon the type of corporation, the corporate financial situation, the quality of management and the quality and composition of the supervisory board. The frequency of board meetings may vary from company to company and range from two to three meetings a year to one meeting each month. If serious problems exist, the frequency of meetings may increase to daily if required.

**Assessment of effectiveness**

It is difficult to assess the effectiveness of boards (Boot, 1995), because much depends on the experience and expertise of individual members. Furthermore, interaction and co-operation with the board of management also affects effectiveness. Generally, the supervisory board receives similar, but more aggregated, information than the board of management. The supervisory board may receive periodic (quarterly) financial and non-financial information about corporate activities. This may include information required for: reviewing the financial position of the entity; information about specific events, transactions and/or circumstances; information about the compliance with law and legislation and procedures; prospective information; and information about strategy, policy and organisation (de Mare, 1993).

The supervisory board should be interested and critical without becoming involved in minor details. In any event, a supervisory board will perform better if management is capable and is providing the board with sufficient timely information. Practice, however, may not live up to this. Anecdotally, criticism exists regarding the role and functioning of supervisory boards.

The perceived lack of independence of the supervisory board, its uncritical attitude, and the lack of time to fulfill its function properly have been debated (Boot, 1995). Structural weaknesses, are a serious issue, and Glasz (1995b) indicated examples where the supervisory board was not capable of handling the situation adequately. Glasz, however, also cited examples where the supervisory board took its functions seriously
and acted thoroughly and correctly in difficult situations. In general, much depends on the actual financial situation of the company and the quality of the supervisory board members (Glasz, 1995).

Maassen and van den Bosch (1999) questioned the independence of supervisory boards. They concluded that Dutch directors often by pass the formal structures of the two-tier board system by means of informal and semi-informal arrangements. For instance, it may be common practice for the supervisory board to organise joint meetings with the entire management board. These findings suggest the incorporation of one-tier board attributes into the Dutch two-tier board.

Glasz outlined three approaches to remedying the structural weaknesses of supervisory boards. The first approach concentrated on 'knowing the business' of the company and acquiring general knowledge and experience. The second aimed to establish proper supervision and sufficient information flows to and from the supervisory board. The third approach institutionalised the direct contact between the supervisory board and the external auditor. The board should not be dependent solely on management for its information. Such an environment may result in the board being less aware of unanticipated developments than they might otherwise be. Auditors play a central role in informing the board of the current situation and going concern status of the company (Glasz, 1995).

The following conditions, amongst others, have been suggested to ensure the adequate functioning of the supervisory board (de Mare, 1993):

- a clear job description of the specific tasks of the board;
- an agenda for board meetings which includes fixed subjects such as discussion of sub-committee meetings, approval of previous minutes, key issues and issues rising from the internal information system;
- fixed dates for meetings to consider important events or data;
- early testing of policy before policy is translated into plans; and
- periodic evaluation of the composition of the board.

Finally, it is worth noting that van Moerkerk's empirical research on audit committees and internal auditors suggested that internal auditors were not satisfied with the functioning of supervisory boards. Three out
of nine internal auditors noted that reporting by the audit committee to the supervisory board had a negative influence on the independence of internal audit (van Moerkerk, 1992).

Comment and key issues

The supervisory board's remit is to act for the benefit of the corporation as a whole. Its members are formally independent, elected by co-option and have the power to suspend and remove executive directors if this course of action is in the interest of the corporation as a whole. Aspects of the supervisory board system, however, have come under scrutiny: the system of co-option which creates an old boys network; and the lack of independence resulting from being too close to management and reliant on them for information.

The Dutch supervisory board, unlike one-tier boards such as those which feature in the UK system of corporate governance, does not have responsibility for managerial and operational activities. Instead, supervisory board members are responsible for providing advice to the executive board and for monitoring this board on behalf of all interested stakeholders. There is a clearer dichotomy (in law and function) between supervisory and management board members in the Netherlands than there is between executive and non-executive directors in the UK. It may be, therefore, intuitively appealing to argue that supervisory board members are likely to engage in more independent behaviour than non-executive directors in the UK. If this line of thought is accepted, then it may also be assumed that the supervisory board concept may enhance the independence of the external audit function. It is not possible to conclude that the traditional two-tier structure has been more effective than the one-tier alternative in terms of interaction with the auditors. It seems likely, however, that the contemporary corporate governance debate will strengthen the relationships between the supervisory board and the internal and external auditors. However, the fundamental desirability of the two-tier board system has been questioned (Owen, 1995a,b). Substantive
work on this is required before a firm conclusion can be reached and supervisory boards may exhibit independence problems as has been argued by recent research.

Key issues

In summary, the key issues identified from the literature for investigation at the fieldwork stage of the project are:

- changes in the strength of the relationship between the supervisory board and the internal and external auditors;
- whether supervisory boards could exercise the functions, as proposed by ICAS (1993), of the FRAC and ARP.
- the role and functions of the supervisory board;
- the effectiveness of the supervisory board; and
- the assessment, by the supervisory board, of the effectiveness of other internal monitoring bodies.

Endnotes:

1 Art 140-164 (NV) and art 250-274 (BV) BWII
2 Art 140/2 en 250/2 BW (Dutch Civil Code) II.
3 At least one board member should attend the consultation meeting (twice a year) of the works council and the general manager (Art 24, Works Council Act (WOR) Art 24, Works Council Act (WOR). At the request of the works council, the supervisory board will also attend a meeting where important decisions are to be taken (Art 140-164 (NV) and art 250-274 (BV) BWII and art 24 and 31a WOR, Luijk 1980).
4 Art 393 BWII
5 Art 159 and 269 BWII
6 Art 161 and 271 BWII
CHAPTER SIX

COMMUNICATION INTERFACES BETWEEN
AUDIT COMMITTEES,
INTERNAL AUDIT AND EXTERNAL AUDIT

The three principal parties involved in the ICAS (1993) proposals are audit committees, internal audit and external auditors. If the proposals are to be implemented to any significant degree, then relationships between three distinct parties will be crucial. The interaction between these parties has been considered as critical, to varying degrees, in the literature and Porter (1994) has designated them as the ‘audit trinity’. In this chapter, the three possible two-party relationships arising from this audit trinity are considered. The focus is on communication interfaces, as interfaces arising from each monitoring body’s functions and responsibilities have been covered in earlier chapters. A final section offers comment and identifies key issues for investigation at the fieldwork stage.

It should be emphasised that the difference between the one-tier and two-tier corporate governance system does influence the importance of the role and function of the audit committee. In the two-tier system, the audit committee is seen as a sub-committee of the supervisory board because its duties and responsibilities are formally the duties and responsibilities of the supervisory board. This explains the recommendation of The Peters Report (1997) that each supervisory board should ‘consider whether to appoint an audit committee from its midst’.

Interfaces between audit committee and internal audit

The audit committee has two key functions in relation to internal audit: oversight responsibilities; and strengthening the position of internal audit within the organisation. Well-developed links between the audit
committee and internal audit should be regarded as a matter of fundamental importance, in that each body has an interest in the monitoring function. It will often be easier for the audit committee to initiate contact than *vice versa*, because of the relative status of the two bodies within an organisation.

**The UK**

*The Cadbury Report* (1992) emphasised the importance of close collaboration between internal audit and audit committees and argued that a clear reporting line between the two must be delineated without reference to executive management. This may involve the chief internal auditor attending audit committee meetings, as well as other forms of communication between the chief internal auditor and the audit committee. The IIA briefing note *Audit Committees of the Board* (IIA(UK), 1994) requires that the chief internal auditor report audit findings to the audit committee, highlighting significant findings and recommendations.

**The Netherlands**

Typically, the audit committee operates as a sub-committee of the supervisory board. However, an interface between the supervisory board and internal audit is seldom established in practice, and this contact has not been identified in Dutch literature. If there is contact, then communication will generally flow through the board of management. Internal audit, however, believes that its independence is strengthened in cases where it can report directly to the supervisory board or audit committee (van Moerkerk, 1992). This may indicate that existing channels of communication between the supervisory board and internal audit (through the board of management) leave room for improvement.
The US

In a US context, *The Treadway Report* (1987) recognised the importance of an open line of communication between the audit committee and internal audit at all times. In response, the IIA issued SIAS 7 (IIA, 1989) in the US which suggests that this open line operates best when the director of internal audit regularly attends and participates in audit committee meetings on relevant matters. A survey carried out by Verschoor (1992) indicated that in 89% of the 358 responding organisations, the director of internal audit attended audit committee meetings and made oral or (less commonly) written presentations to the committee. A further survey by Oliverio and Newman (1993) indicated that, in general, respondents appeared to welcome opportunities to meet with their audit committees.

Oversight of internal audit activities

A robust oversight function for audit committees in respect of internal audit is consistent with the ICAS (1993) recommendations that the FRAC should be responsible for the appointment of the chief internal auditor, the planning of the department’s work and budget approval. Vinten and Lee (1993), however, suggested that the positioning of internal audit under the control of audit committees may confer executive functions on the committee and thereby weaken its supervisory and advisory roles.

Nevertheless, audit committees rely inevitably on internal audit for much of their information concerning corporate activities (Apostolou and Strawser, 1990). Arthur Andersen (1994) observed that members of newly-formed audit committees look to internal audit for comfort, assurance and protection.

Rezace and Lander (1993) identified, in a US context, the following areas that they argued should be the subject of communication between internal audit and the audit committee:
• **Internal audit scope and approach:** This should include *inter alia* how the internal auditor evaluates the internal control system, the adequacy of control systems, the extent of co-operation with the internal auditor, areas of major audit emphasis, uses of information technology by internal audit, timetables and quarterly findings of internal audit.

• **Suggestions made to management:** The audit committee should review the reports of the internal auditors and management's responses thereto and should be aware of any fraudulent activities identified by internal audit.

• **Compliance with codes of conduct:** Audit committees should be informed regarding management's compliance with codes of conduct on ethical behaviour, and their compliance with laws and confidentiality.

• **Disagreements with management:** Disagreements between internal audit and executive management should be discussed with the audit committee.

**Strengthening internal audit**

Audit committees may strengthen and enhance the position of the internal audit function in various ways. Two possibilities are:

**Monitoring of internal audit charter**

The IIA (1978) suggested the preparation of an audit charter documenting the purpose, responsibility and authority of internal audit. This would provide a point of reference for the audit committee, which could review the charter periodically to assess its adequacy. In its review of the charter, audit committees should ensure that this provides an adequate framework for internal auditors to discharge their responsibilities to a satisfactory standard. The most important role an audit committee can play in this area may be to ensure the authority, independence and scope of coverage of internal audit (Vinten and Lee, 1993). Rezaee and Lander (1993) also stressed the importance of audit committee involvement in the periodic assessment of the charter by the chief internal auditor and this point is also made in the IIA briefing note on audit committees (IIA (UK), 1994).
Raising of the profile and authority of internal audit

Cadbury (1992) recommended that where internal audit exists the audit committee should ensure that it is adequately resourced and has appropriate standing within the company. Arthur Andersen (1994) highlighted the view of internal auditors that a strong audit committee is vital in helping internal audit to maintain its independence.

Allison (1994), writing from a UK perspective, stated that one of the audit committee's major responsibilities is to ensure that the internal auditor has support, from the committee and the whole organisation. Cable and Wireless reported that one function of the audit committee is to market internal audit as a function that facilitates the work of management (Jack, 1993). Their chief internal auditor stated that he considers it important to have an audit committee as it helps him to do his job (Jack, 1993).

In the US survey by Verschoor (1992), 33% of the respondents reported that the audit committee had suggested an increase in scope of the annual internal audit work and nearly 50% suggested the addition of a specific new audit.

Interfaces between internal audit and external audit

For the ICAS (1993) proposals to work, a high degree of co-operation between internal and external audit will be required.

The UK

No literature on this topic specific to the UK was identified.

The Netherlands

The activities of the Dutch external auditor depend on the organisation of internal audit, the mix of audit activities and the quality of internal audit work. Consequently, the external auditor will seek out information on these issues. It is common Dutch practice that internal
and external auditors co-operate. In some cases, the internal auditor certifies the internal annual accounts, and therefore, plays an important role in the audit process of the external auditor.

Co-operation between the internal and external auditor can affect the level of the external audit costs in a positive way. For co-operation between internal and external audit, to be productive, however, requires close communication links. In some organisations, this co-operation leads to a joint management letter. The external auditor, however, has sole responsibility for the audit opinion expressed publicly and that responsibility is not reduced by any reliance on internal auditing.

According to Vecht (1989) disputes between internal and external auditors are seldom caused by duplication in their activities. In his opinion, these disputes are a sociological phenomenon; people are critical of related, but different professions.

Blokdijk et al. (1993) described how, as a consequence of growing competition between auditors, the search for more efficient ways of auditing has grown more intense. The need for effectiveness and efficiency will encourage internal and external auditors to co-operate. It is important to note that most auditing research and development activity takes place within the large international accountancy firms. Competitive pressure, however, would be likely to result in new audit approaches and techniques being disseminated from external auditors to internal auditors.

Not much is known about the interfaces between audit committees and internal and external auditors. Based on van Moerkerk's study (1992), it can be assumed that internal auditors are almost always represented on the audit committee while external auditors are sometimes represented and most of the time attend the meetings. Internal auditors see the audit committee as an independent sounding board. In their view, communication with the external auditor positively influences the effectiveness of the audit committee.

The US

US literature covers three main areas relating to internal and external audit interfaces: case studies of successful co-operation; problems impeding co-operation; and factors influencing co-operation.
Case studies of successful co-operation

Examples of cases in which internal and external auditors have worked together successfully are documented in the literature. For example, Moore and Hodgson (1993) discussed how Du Pont’s internal audit group and Price Waterhouse collaborated to improve the efficiency of both audit groups without sacrificing quality or independence. Anderson (1994) described how Price Waterhouse and the internal audit function of Continental Bank worked together to achieve a ‘truly integrated audit approach’ designed to minimise total audit expenses without loss of quality in internal and external audit functions.

Problems impeding co-operation

There may be significant problems as far as co-operation between the internal and external auditors is concerned. Huston and Warrick (1993) raised the question of how internal auditors will adjust to external review. Potential problems may be due to perceptions on the part of internal auditors in relation to how they are regarded by external auditors; it may be that an expanded internal audit function may be regarded as low level by the external auditors. Arthur Andersen (1994) pointed out the view of internal auditors that the relatively poor image of internal audit has made it difficult for the profession to attract and retain quality staff. Ward and Robertson (1980) carried out a survey of both internal and external auditors. Around 50% of the respondents in both categories indicated that internal auditors were not being relied upon to the fullest extent possible. In general, reliance on internal audit was focused around reliance on internal controls and was largely ad hoc in nature. Other evidence suggested that external auditors rely less on internal auditors in high materiality areas (Whittington and Marghein, 1993). Peacock and Pelfey (1989) found that internal auditors who worked with external auditors believed that external auditors did not utilise fully the internal auditors’ expertise.

Ward and Robertson (1980) provided evidence of the extent of a related problem, the reaction which external auditors expected from internal auditors on being subjected to external review. Twenty-six per cent of
external auditors expected or anticipated resentment on the part of internal audit on being subjected to review by external auditors. Mauriz (1985) concluded that internal auditors viewed their interactions with external auditors as the least appealing part of their job. This evidence is corroborated by Huston and Warrick (1993), whose survey identified that only 55% of internal audit respondents agreed that there should be periodic external review of internal audit. This evidence may suggest that the close relationship envisaged between internal and external auditors by the ICAS proposals may engender a degree of resentment.

Another problem is that internal and external auditors make judgments differently in the areas of substantive tests and subjective assessments (Moore, 1993). This study also identified a consistent bias by internal auditors not to place as much reliance on the internal control structure as external auditors do.

The two sets of auditors also appear to have different views of how internal audit quality is assessed. Some internal auditors believe that SAS 65 *The auditor’s consideration of the internal audit function in an audit of financial statements* (AICPA, 1991) misinterprets important aspects of the internal auditing process and omits any guidance with regard to how the external auditor should use or rely on relevant internal audit work (Barrett, 1990). Lampe and Sutton (1994) looked at the comparative evaluation of internal audit quality by external and internal auditors in a North American context. This was focused specifically around the APB’s SAS 500 Exposure Draft *Considering the work of internal audit* (APB, 1995). The authors found that some items suggested in SAS 500 are not considered critical by internal auditors and that several factors that internal auditors believe to strongly influence the quality of their work are not suggested by SAS 500. The implication is that there may be significant disagreement because of the differing views of internal and external auditors on internal audit quality.

**Factors influencing co-operation**

Whittington (1989) noted that effective communication reduces the overlap of effort between external and internal auditors but that it requires joint planning, open lines of communication and a consideration of various
aspects of human relations. Brody et al. (1998) investigated the impact of internal audit quality differences on auditors’ willingness to place reliance on the work performed by internal auditors. Their results indicated that external auditors do pay attention to internal audit quality differences. Also the existence of communication barriers between external and internal auditors was likely to lead to external auditors increasing the audit hours assigned to a specific task rather than to discussing the situation with the internal auditors.

Further evidence suggests that fruitful co-operation between external and internal auditors is likely to occur only where there is a long-term relationship between the two auditors (Campbell, 1993). Tiessen and Colson (1990) found that the form of the working relationship between the internal auditor and the external auditor was more important in determining the external auditors’ reliance evaluations than the specific work performed by internal auditors. Interestingly, Tiessen and Colson identified objectivity or independence of internal audit as a significant variable in reliance evaluation only in certain closely specified circumstances. It is interesting that the last two studies cited both highlight the actual working relationship between internal and external auditors. This has implications for the successful implementation of the ICAS (1993) proposals.

**Interfaces between audit committees and external auditors**

This is the third and final two-party relationship between members of the audit trinity.

The UK

*The Cadbury Report* (1992) recommended that the external auditor should normally attend audit committee meetings. Furthermore, Cadbury recommended that the audit committee should have a discussion with the external auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
The Netherlands

The audit committee is considered to be a sub-committee of the supervisory board; it is therefore appropriate to consider the interface between the supervisory board and the external auditor, the nature of which is well established in practice. In the case of a compulsory audit, the external auditor should by law (Art 393 BW 2) report on the audit to the supervisory board and to management.

The external auditor will support the supervisory board in undertaking its responsibilities by, for example, providing reports, figures and analyses. In addition, the supervisory board will support the external auditor in the audit and advisory role by, for example, providing advice, back up and support. Good mutual understanding and regular contact is, therefore, to the advantage of both the supervisory board and the external auditor.

The quality of the information received is essential to the proper functioning of the supervisory board. In this respect, the auditor should review the reliability and relevance of the information presented to the board by other parties, eg the board of directors.

According to some authors, at least once a year the supervisory board should, in the absence of the board of management, discuss the general situation of the company with the external auditor (de Mare, 1993; Bak, 1982; and Glasz, 1995). In most cases, however, management is present at these meetings. It is common practice for the external auditor to be present at the board meeting to discuss the financial reports and, in many cases, the supervisory board also receives copies of the external auditors' management letters. This contact is extended when an audit committee is installed.

Much, however, depends on the position taken by management and the way in which the supervisory board reacts to this. A dominant board of management which refuses direct contact between the auditors and supervisory board and restrains such contact can be paralysing. However, a board of management which supports and encourages such contact can have a positive effect. For the most part, it is not the external auditor who initiates communication with the supervisory board. The auditors'
contact with management prevents this occurring. It is, therefore, up to the supervisory board to ask for this communication and, if required, to persuade the board of management of its necessity (Glasz, 1995).

De Mare outlined the following subjects which may be discussed between the supervisory board (or audit committee) and external auditor (de Mare, 1993):

- financial statements;
- auditor's report and the scope of audit; and
- items related to the functioning of the board of management (without the attendance of the board of management).

*The Peters Report* (1997) included a recommendation that the supervisory board or the audit committee should hold a meeting with the auditors at least once a year. The agenda should include, at a minimum, the range, planning and findings of the audit as well as aspects of financial reporting. It should be emphasised that *The Peters Report* made no distinction between the internal and external auditors. Both should, therefore, attend these meetings.

The US

Verschoor and Liotta (1990) discuss the requirements of US Auditing Standards SAS 60 *Communication of internal control structure matters noted in an audit* and SAS 61 *Communication with audit committees*. SAS 60 requires external auditors to report formally to the audit committee any matters considered to be significant deficiencies in the design or operation of the internal control structure. SAS 61 clarifies the nature of information needed by audit committees for proper oversight of financial operating and is designed to help audit committees understand their responsibilities. The authors observe that although presently only required in the US, these practices are helpful in all countries where non-employee directors exercise oversight responsibilities.
Comment and key issues

Several matters are likely to require attention before effective and optimum relationships between audit committees and external and internal auditors may be operationalised. Particularly important in view of the enhanced role proposed for internal audit is the relationship between the audit committee and the internal audit function. It has been argued that the support and oversight of the audit committee is fundamental to the independence of internal audit. Too great a move towards directing internal audit, however, may give rise to the audit committee exercising what is effectively a quasi-executive role which may weaken its moral authority in relation to supervision and monitoring.

The relationship between internal and external auditors is problematic. In relation to implementation of the ICAS proposals, matters for investigation include: possible perceptions by internal auditors that their status has been diminished vis à vis that of external auditors; and perceptions on the part of accountants and others that there is a reduction in the attractiveness of internal audit as a career. External auditors rely on trainee accountants for much routine audit work and this has a favourable effect on total audit costs. Similarly, if the ICAS proposals were to be implemented, it might become necessary for internal audit to recruit a regular and comparable supply of new entrants to the accountancy profession. This may be difficult if internal audit is perceived as a less attractive career option than public accounting. Other related matters include the possible perception on the part of external auditors (or assessors) that internal audit is a relatively low-level function and the issue of whether or not internal and external auditors make judgments on similar bases. Nevertheless, the Dutch experience demonstrates that external and internal auditors can work together effectively even to the extent of issuing joint management letters. However, more significant than these matters in the longer term, may be the adoption of a new audit approach by the international accountancy firms, the increasing involvement of internal and external auditors in the assessment of internal control and the outsourcing of internal audit functions.
In relation to the relationship between audit committees and external auditors, there appears to be no major issues which require highlighting and audit committees already work effectively with external auditors in many cases. In the event of implementation of the ICAS proposals, this involvement is likely to decrease as the balance of work shifts more to internal audit. External audit, however, may continue to play an important role in guaranteeing that important information is communicated to the audit committee.

**Key issues**

The key issues identified from the literature on interfaces for further investigation at the fieldwork stage of the project are:

- the relationship between audit committees and internal auditors;
- the relationship between internal and external auditors;
- the perceptions of internal and external auditors regarding the status of internal audit; and
- the overall relationship between audit committees, internal auditors and external auditors.
CHAPTER SEVEN

SUMMARY OF LITERATURE REVIEW AND APPROACH TO DUTCH FIELDWORK

Chapters three to six reviewed the available literature on the corporate governance structures existing within the UK, the Netherlands and elsewhere. This review had particular regard to the audit function, concentrating particularly on those internal monitoring bodies which are relevant to the Auditing into the Twenty-first Century proposals.

This chapter summarises the main points from the literature review which have implications for the fieldwork stage; describes the approach taken to the Dutch fieldwork; and acknowledges the limitations of the case-study approach.

Summary of the literature

Literature on three internal monitoring bodies has been examined. Two of these bodies, audit committees and internal audit, are of particular relevance to the ICAS proposals and feature in the corporate governance structures of both the Netherlands and the UK. Audit committees have a higher profile in the UK and in other Anglo-Saxon countries than in the Netherlands. While, historically at least, internal audit in the Netherlands has enjoyed a relatively higher profile and status. The ARP is an additional internal monitoring body which features in Auditing into the Twenty-first Century but little literature could be identified on this proposal. The remaining internal monitoring body examined in this report, is the supervisory board. This does not feature in the ICAS proposals but is central to the Dutch system of corporate governance. A further Dutch internal monitoring body exists in the form of the works
council and was included in the agenda for the Dutch fieldwork but, as works councils are of little relevance to the ICAS proposals, the related literature does not form part of this report.¹

Audit committees

The literature review on audit committees highlighted interesting points of contrast between the Dutch and the Anglo-Saxon models. Dutch committees are still relatively less common, due perhaps to a combination of two factors. First, the prominence within Dutch corporate governance of the supervisory board which has tended traditionally to exercise authority over those areas which in countries such as the UK fall within the remit of the audit committee. Second, in the UK *The Cadbury Report* has had a catalytic effect on the rate of formation of audit committees to the extent that these are now found almost universally in major companies. It remains to be seen whether *The Peters Report* will have a similar effect in the Netherlands.

Dutch audit committees appear to operate in a manner quite distinct from UK and US current practice. The Dutch committee tends to operate as a sub-committee of the supervisory board and, therefore, acts as a means of formalising contact between the supervisory board and the internal and external auditors. In this role of facilitating communication, independence is a less fundamental consideration than it is under the Anglo-American model. This is an interesting issue in the light of recent literature suggesting that when assessing the work of bodies such as audit committees their contribution to the creation of *dialogue* within organisations may be as important as traditional considerations of independence. Dutch corporate governance, with its culture of openness, emphasises communication and dialogue.

The fieldwork stage engages with the question of assessing these competing audit committee paradigms. An important consideration for the Dutch fieldwork stage is the extent to which Dutch-style audit committees, particularly in relation to their interaction with internal audit, provide a model for the establishment of FRACs.
Internal audit

An important theme emerging from the literature review is the way in which internal audit in both countries have tended gradually to assume some degree of operational audit responsibility. Often this appears to have occurred in conjunction with less financial audit work being undertaken, but this may not necessarily be the case in all instances. This matter has major implications for the implementation of the ICAS proposals and the functions and responsibilities of internal audit receive prominence in the interview agenda for the fieldwork stage.

Developments since the publication of Auditing into the Twenty-first Century in corporate internal audit practice and in the accountancy profession add further complications. The increasingly common practice of outsourcing internal audit to accountancy firms may lead either to financial audit disappearing entirely from many internal audit functions or to the disappearance of some internal audit functions altogether. At the same time, changing external audit methodologies and an increasing emphasis on areas such as risk assessment may lead to a blurring of the distinction between internal and external audit.

The independence of internal audit is seen as fundamental to the credibility of the ICAS proposals. We noted that in the Netherlands internal audit appeared to possess a status and a perceived independence greater than that which would be expected intuitively for an internal body. This issue is explored in the fieldwork by investigating the formal reporting framework for internal audit and the way in which internal audit interacts with other monitoring bodies within the organisation.

Another issue of strategic importance for internal audit in the context of Auditing into the Twenty-first Century is effectiveness. Our literature review revealed that such material as there was on internal audit effectiveness tended to be predictable in nature. We also identified, in the case of internal audit, a probable absence of those external pressures which exist to enhance audit quality in an external audit environment. The fieldwork interview agenda takes account of these issues.
Supervisory boards

Recently the role and functions of the Dutch supervisory board has been questioned. The independence of the supervisory board may in some cases be regarded as problematic and there have been suggestions to the effect that the supervisory board might play a more active role in corporate governance than hitherto. Some commentators have indicated that the supervisory board might appropriately represent a plurality of stakeholder interests including, for example, employees and creditors. In this way, the supervisory board might be remodelled to reflect contemporary concerns about the stakeholder society.

A further issue for consideration is whether the supervisory board might effectively subsume the functions proposed by ICAS for the ARP and by so doing avoid what might be perceived as an unnecessary additional layer of bureaucratic governance.

Approach to the Dutch fieldwork

Three large companies were approached and agreed to participate in the project. Interviews were conducted with a variety of officials in each company.

Aims of the Dutch interviews

The interviews were designed to explore the ways in which audit aspects of the Dutch corporate governance system operate within the companies interviewed. The specific objectives were to:

- identify the functions and responsibilities of internal audit, supervisory boards and audit committees in the companies visited and establish how these bodies operate (chapter eight);
- establish how these bodies inter-relate with each other and interact with the executive board and external auditors (chapter nine); and
- establish how their effectiveness is measured and assess whether they are perceived as effective in their operation (chapter ten).
The case companies

All three companies are listed on the Amsterdam Stock Exchange, and are profitable and expanding. Each operates an internal audit function and has a supervisory board and an audit committee in place. Background information on each of the companies is as follows:

Company A, with group companies operating in more than forty countries, operates in an industry which is project oriented and undertakes projects on a worldwide basis. It is labour intensive and depends on a workforce working at remote locations. Continuous monitoring of individual projects is paramount.

Company B also operates on a worldwide basis in a labour intensive industry, with a workforce who have specialist qualifications. The industry is highly regulated and effective control systems are particularly important.

Company C is an international retail and consumer products organisation with the need to control performance at a wide variety of outlets in different trading conditions ranging from the US to former eastern block countries.

Selected indicators based on information extracted from the 1995 statutory accounts are:

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<tr>
<th></th>
<th>COMPANY A</th>
<th>COMPANY B</th>
<th>COMPANY C</th>
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<tbody>
<tr>
<td>Turnover</td>
<td>NLG 5,000m (GBP 2,000m)</td>
<td>NLG 15,000m (GBP 6,000m)</td>
<td>NLG 30,000m (GBP 12,000m)</td>
</tr>
<tr>
<td>No of employees</td>
<td>20,000</td>
<td>70,000</td>
<td>130,000</td>
</tr>
</tbody>
</table>

Structure of the Dutch interviews

Interviews were arranged with a number of officials in each company. The identity of the officials varied, but typically the views of chief executive (CE) and/or finance director (FD), supervisory board chairman (SB), chief internal auditor (CIA) and works council chairman (WC) were sought. No interviews were held with external auditors since the primary emphasis of the project was on the functions of and relationships between the internal monitoring bodies. The interviews were semi-structured
around the basic interview agenda, which was provided to the participants prior to the interview visit. A consequence of this approach was that interviews did not necessarily follow an identical pattern. Unusual or unexpected points made by interviewees were explored in depth to identify the underlying rationale.

In all cases, it was agreed that interviewees would give their own personal opinions on the way they saw corporate governance issues in the organisations for which they worked. Occasions on which they were speaking more about Dutch corporate governance in general terms are identified as such. The views expressed are those of the representatives of the particular internal body under review and also the impressions and opinions of individuals interviewed because of their connection with another monitoring body. The input from 'non-members' was especially important as it gave balance to the view of members, who might arguably wish to present a wholly positive view of the effectiveness of their own board or committee. This variety of perspectives meant that the interviewers gained a more complete picture of how particular bodies functioned in the case companies. Where appropriate, distinction is made between the views of 'members' of the particular body and others.

A total of thirteen interviews were conducted, each lasting between one and two hours. These were recorded, the transcriptions sent to the interviewees for comment and amendments made as appropriate. Quotations cited in the text of the report are from the transcripts and the remainder of the material in the report is based on information contained in the transcripts and inferences drawn from these by the authors. The interview agenda is presented in Appendix 1.

Limitations of approach

While the case studies provide helpful examples of the way in which the bodies connected with audit operated and related to one another, a sample of three targeted companies does not give a comprehensive picture of Dutch corporate audit. If unlimited time and resources had been available, the number of interviewee companies could have been extended substantially. Various different scenarios might then have been explored.
For example, it would have been interesting to explore the effectiveness of the audit function in companies that had outsourced internal audit, or discontinued it altogether. Relationships within companies in financial difficulty or in a contracting market might well have been different from those in the companies chosen, which were all profitable and expanding. The extent to which the supervisory board adopted a ‘hands on’ approach might vary with its confidence in company management.

Internal audit in the companies interviewed concentrated largely on control issues and the report focuses primarily on this aspect of audit work rather than on those dealing with the true and fair presentation of accounts and other related matters. The literature review indicated a shift away from the financial statement internal attestation functions traditionally associated with Dutch internal audit. It was considered that these were largely the concern of external auditors, who were not interviewed. There is, therefore, scope for further research into the relationships among monitoring bodies and between these bodies and executives and external auditors within a variety of operational and financial situations.

A further limitation is that the views expressed in the interviews were personal, reflecting the interviewees’ own experiences and outlook, as interested parties. We were always conscious that in any situation individuals might be giving an ‘official’ or ‘sanitised’ account of the matter under review. In our judgment, however, the interviewees were open and frank.

Notwithstanding these limitations, the participating companies are influential players in the Dutch business community and the emergence of common themes in the discussions was apparent. It is considered, therefore, that the conclusions drawn do shed light on the desirability and feasibility of the ICAS (1993) proposals.
Endnotes:

1 It should be pointed out, however, that features of contemporary society such as the European Community establishment of the Social Chapter and the rhetoric of the stakeholder society as articulated by the UK Labour government elected in 1997 may combine to create a movement to establish bodies analogous to Dutch works councils within UK corporations. There are already instances of UK companies establishing works councils. One prominent example is that of Stagecoach plc (The Herald, 1998).

2 Interviews were conducted with works council chairmen in all the companies and the functions, relationships and effectiveness of works councils were also discussed with other officials interviewed. It was apparent from the interviews that the principal task of works councils was to attend to the welfare of employees and to ensure equity in management's dealings with staff, particularly in cases of major reorganisation and reconstruction. Works councils have no formal contact with either internal or external auditors. For this reason, the discussions in relation to works councils have been excluded from this report.
Chapter Eight

Functions and Responsibilities of Dutch Internal Monitoring Bodies

This chapter sets out the functions, responsibilities and operations of the three different internal monitoring bodies (audit committee, internal audit and supervisory board) within the companies interviewed. The description of the role that each body plays in the corporate governance structure of the companies visited allows a comparison to be made with the ICAS (1993) proposals to assess the extent of the parallels between them.

Audit committees

In the case companies, the audit committees operated broadly as indicated in the literature. In company A the entire supervisory board constituted the audit committee, since all members wished to be involved in the detailed discussion of audit and accounting matters. In company B, the audit committee operated as a sub-committee of the supervisory board, it was called the ‘special committee’ of six supervisory board members (including the chairman). In addition to audit committee duties, it had responsibility inter alia for director nomination and remuneration. In company C the audit committee was a sub-committee of three members of the supervisory board, (including the chairman).

Functions and responsibilities

The audit committees did not consider themselves as a buffer between the external auditors and management as, in their opinion, there was no need for such a function. They also played only a secondary role in the
appointment or removal of the external auditor and in agreeing audit and non-audit fees. The reason for this was that their primary function was the supervision of the directors, and they regarded their work with the auditors as a means to that end, rather than an end in itself.

The main functions of audit committees in the companies visited were the supervision of the effectiveness of the total audit process, especially the issue of control effectiveness and informing the supervisory board of the background to the periodic financial statements. Discussions at meetings were extremely detailed and a large volume of documentation was made available. For example, the finance director of company C described the package of information produced for the audit committee on a regular basis as including quarterly results, cash flow, Economic Value Added calculations and other performance indicators split by company, by product and geographically. Similarly, in the other companies interviewed, a high volume of such detailed information was supplied routinely. The finance director of company A commented:

*Lots of detail is given - forecasts, reports and exceptional information. Also close liaison at all times and levels means that they are well informed.* (Company A FD)

In addition to periodic reports and analyses of financial performance there were verbal reports on progress and problems from internal and external auditors, and periodic management letters were discussed in detail. For example:

*Four times a year there is an opportunity for both internal and external auditors to make clear if they are happy or unhappy ... and answer questions asked by members of the committee.* (Company C SB)

The approach adopted was generally retrospective, examining historical data, discussing findings of auditors and problems encountered. The relationship between internal and external auditors was also addressed in this forum, as the supervisory board, through the medium of the audit committee, was anxious to maximise co-operation between the two sets of auditors and ensure that no problems had arisen in their relationship. The finance director of company A explained:
The [external auditors] usually make a statement of some length highlighting their important findings then discussion takes place .... Normaly the meeting is quite lengthy ... and they explain how the audit work has been set up, what the relations are between external and internal audit, how the internal organisation is working, what are their shortfalls, their strengths and weaknesses. (Company A FD)

Audit committees in the companies tended not to become involved to any great extent in audit planning, generally leaving this to liaison between internal and external audit. There were exceptions, however, and one supervisory board member indicated that:

... we [audit committee] may say we are concerned about specific things and would tell the auditors that we would like them to look at these, but this is not normally done. (Company B SB)

Although the supervisory board through the audit committee tended not to have a heavy-handed approach to the control of internal audit work, it was stressed that this was against the background of companies performing well with open relationships and no glaring weaknesses or financial difficulties. In a situation where these problems were present, supervisory board members stated that they would adopt a more ‘hands on’ approach to their work, and have closer contact with the auditors both directly and through the audit committees.

Operations

In company A, the audit committee met six to seven times a year. Company B’s special committee met several times a year and twice a year audit committee matters were included on the agenda. Company C held four meetings per year. In companies B and C, membership of the audit/special committee rotated every two to three years, with the exception of the chairman and vice-chairman of the supervisory board who had a permanent presence on the committee.
Most interviewees believed the most effective way to deal with the issues was to discuss them in detail in the audit committee and summarise the findings in a subsequent meeting of the full supervisory board. One internal auditor explained:

*The audit committee functions as a sub-committee of the supervisory board. All kinds of conclusions presented in the audit committees are discussed further by the president of the audit committee ... in the supervisory board. For example, we have on Monday an audit committee, on Tuesday or Wednesday the supervisory board and a main agenda point is the minutes of the audit committee.* (Company C CIA)

The chief executive in the same company commented:

*I think the audit committee is very helpful in a two-tier system because it deals in more detail with many of the issues than the supervisory board meeting has time for.* (Company C CE)

One interesting feature was that, as the Dutch literature indicated, all audit committee meetings were held in the presence of auditors and executive management. One supervisory board member commented:

*In the special committee meeting the chairman is always present and also the board member responsible for the topic being discussed. But when we discuss the management letter then other members of the board come in and attend the meeting for their specific subjects.* (Company B SB)

This was a cultural issue and all interviewees were emphatic that it in no way inhibited the discussions. One supervisory board chairman said:

*... the last question at the audit committee meeting to the external auditor and to the internal auditor is ‘Is there anything you want to raise in the presence of or in the absence of the chairman of the management board?’.* (Company C SB)

Although the request for a private meeting would be extremely unusual and could cause embarrassment, especially if it was made at an audit committee meeting without prior warning, the possibility did exist
for it to happen. One supervisory board member referred to his experience in a previous company, where an external auditor had requested a private meeting to discuss information access problems. The issue of management presence at meetings is a potential problem, however, and is discussed in chapter ten.

Comparison with the ICAS (1993) proposals

The Dutch audit committee relied on internal audit to provide it with assurance that management information systems and internal controls were adequate and operating satisfactorily and relied on input from the audit function to enable it to fulfil its responsibilities. This would also be the case for ICAS (1993)'s FRAC. The composition of the two bodies and their primary emphasis, however, would be different. The FRAC would consist of non-executive directors and its function would be to provide directors with reassurances on financial reporting and auditing matters. The Dutch audit committee, however, consisted of supervisory board members obtaining information on financial reporting, company performance and auditing matters to help it to supervise the activities of the directors and the company. The view was expressed that, because of the greater detachment of the supervisory board members from the executive board than that enjoyed by UK non-executive directors, the Dutch audit committee had the potential to function more independently than the FRAC.

Internal audit

In the companies visited, internal audit operated as the principal vehicle for senior management control within the organisation, enjoying a high profile and considerable authority within the organisation. Its main responsibility to act on behalf of senior management meant that its primary emphasis was on the verification of control effectiveness at all levels. The question arises as to whether this should cover all controls, or only financial controls.
In company A most internal audit time was spent on financial auditing, including financial control work, internal certification of financial accounts for some group companies and other 'traditional' financial audit work. Nevertheless, there was recognition of the need to move towards a wider, operational audit approach.

In companies B and C, internal audit concentrated largely on operational audit work since it was recognised that non-financial controls were as important as financial controls to management, and breakdowns in controls of all types could have a serious financial impact on the company. In addition, the dividing line between operational and financial controls is becoming blurred by the greater integration of systems, and it was believed that the distinction between the two was becoming increasingly artificial.

Functions and responsibilities

The principal function of internal audit in companies B and C was the assessment of the quality of financial, business and electronic data-processing controls, business risk assessment and the economy, efficiency and effectiveness of the organisation, including the assessment of management quality at all subsidiary levels. For example, the function description of internal audit in one company stated the primary task of group internal audit was:

*To form an opinion as to whether the set up and operation of all organisational measures and systems necessary to control business processes in a prudent manner are adequate with a view to internal control, and in this connection to determine whether the information generated by the information systems for use in reports to both internal and external stakeholders satisfies the requirements of internal control.*

(Company B CIA)

The function description document also explained that because of the risk environment in the industry, whereby management stood or fell on the quality of internal control and information from systems, internal
Functions and Responsibilities

Audit’s role was extremely wide and required an operational approach. Although it had several other responsibilities, the primary task of internal audit was to perform operational audits.

The chief internal auditor of company B summed up the function’s mission statement as comprising the following elements:

- guardian/supervisory partner for senior management: an executive consultant specialised in risk management;
- an early warner: to prevent undesirable risks arising in the future;
- a partner with management; and
- auditor and consultant: both reporting on ‘clients’ and offering constructive advice.

Operational audit in company B formed an opinion on the quality of business processes: the way business objectives were attained; and the quality of the organisation to create the pre-conditions for the attainment of these goals. This involved an assessment of the quality of operational and financial controls and of management.

In company C, likewise, there was an emphasis on all aspects of control. As the chief internal auditor said:

I think the whole process of protecting the company from loss of assets and ensuring the continuity of the company ... is the main role of internal audit. That means we see ourselves as internal auditors responsible for ensuring that an adequate system of internal financial and internal operational controls is functioning. (Company C CIA)

Internal audit in these two companies concentrated largely on:

- assessing the effectiveness of controls over all business processes;
- confirming that these controls were being followed;
- reviewing the quality of management information including quarterly forecasts;
- reviewing the effectiveness and efficiency of administration and subsidiary management; and
- protecting the company from loss of assets.
This is consistent with the Dutch literature review, which suggested that internal auditors operate as 'partners in business' with management and act as internal consultants, advising management on risk and control problems. This is also consistent with the UK literature review, which indicated a widening of internal audit's role to an examination of overall performance, including that of enterprise management. Internal auditors in companies B and C were involved in reviewing the effectiveness of management, but only at subsidiary level. The extent of their dependence on the patronage of the parent management board is considered in chapter ten.

In Company A, however, internal audit was somewhat different. The finance director saw internal audit in his company as having a threefold role:

Together with our external auditors they certify the yearly accounts, which is very important. They also do additional work in financial audit in looking at the progress of the respective operating companies. This involves reviewing in detail the quarterly accounts, which provides us with performance information leading up to the year end. This is also very important, and we always rely heavily on what they say on these accounts. Thirdly they look at specific matters which have an operational character. (Company A FD)

It was generally agreed among the directors and internal auditors interviewed that there was a developing trend away from financial auditing to operational auditing. The emphasis in companies B and C on control in its widest sense meant that an operational approach was adopted. This increasing concentration on operational auditing was noted in the literature review in the UK and the Netherlands.

In company A, however, where internal audit still performed a substantial amount of financial auditing work (estimated at 70% of total internal audit time, with 20% on exercises such as turnover certification and the final 10% on operational audit work), its practices mirrored those of the external auditors. The chief internal auditor explained:
We have a contract with ... our external auditors that we work in an identical way to them. This means that we adopt their manuals and have exactly the same audit working papers. Our people go through the same training programme as their people. We hire people at least at the same level as they do. We consider ourselves to be a kind of clone. (Company A CIA)

Some years ago, in this company, attempts to organise operational audits to look at all aspects of the business process (purchasing, tendering etc) on a cyclical basis had met with opposition from local management.

The organisation was not mature enough to accept this kind of systematic approach and they wanted us to concentrate on the financial information rather than on the business. They considered this as an internal activity, an internal responsibility. (Company A CIA)

Despite reassurances from internal audit that there would be no attempt to usurp executives, local management were not prepared to permit internal audit to investigate operational aspects except on invitation on an ad hoc basis. This was the principal reason why testing of business controls as opposed to financial controls had not been performed up to the present time. However, even in this company, it was considered that the future direction of internal audit would increasingly be towards operational auditing at the expense of financial auditing, which would be conducted by the external auditor.

This raised the possibility of outsourcing part or all of the internal audit work and the finance director observed:

If we were to outsource much of the internal audit work we would probably set up an operational audit department within the company just to get the additional information that we need. The problem is that if you put such an organisation into a firm of external auditors, after a couple of years your specific knowledge of the company is going to vanish and then, in my opinion, you need operational audit within the company. (Company A FD)

Since the interviews were carried out, the internal audit function of Company A has been outsourced to the external auditors.
Internal audit carrying out operational audit work faced an apparent conflict between being auditor and reporting on 'clients' and operating as consultants to the same clients. One chief internal auditor noted this conflict:

_There has to be a basis of trust to encourage internal audit's clients to discuss their problems freely and openly with the auditor and find out where improvements can be made. The same auditor, however, examines the client and reports its shortcomings to its superior, which leads to problems being covered up. Internal audit's task is to find an even balance between these two aspects. It can only do so if it works to the highest standards and communicates openly, honestly and straightforwardly._ (Company B CIA)

There was a view that outsourcing internal audit would, if anything, exacerbate this problem as it would tend to accentuate the 'auditor' role at the expense of the 'helper' role. Although the possibility of outsourcing internal audit was not ruled out by companies B and C, it was not considered as an option at present. There was a general feeling that internal auditors offered more than external auditors could. They were colleagues offering support in addition to pure audit. Their knowledge of the company was intimate and this made them more effective than 'outsiders'.

**Operations**

The division of control responsibility between internal auditors and local management was seen as important in all the companies. One finance director stated:

_... controllers should be responsible for ensuring controls are in place ... that's the role of the finance function. And I think the role of audit is to check first of all that controls are in place and that they are being correctly followed._ (Company A FD)

In agreeing with this view, the chief internal auditor of company C foresaw internal audit becoming even more systems oriented:
Our engagement within the company should be how to build a perfect model of integrated control working with the operational management and external auditors together to have an efficient and effective system. (Company C CIA)

He then described a three-level model of control with local management carrying out a self-assessment exercise on the basic business processes, internal audit confirming that these controls were operating and the external auditors investigating internal audit control work and relying on it, thereby limiting their own testing. Such an approach made a clear distinction between the responsibilities of functional management for the setting up and operation of effective business control systems and the duties of internal audit as a check on the control system without actually being a part of the system.

Given the trend towards real-time accounting information produced by integrated computer systems, a control self-assessment approach would have the advantage of building the maintenance of controls into the system at local level. In the UK, the APB noted that the growing real-time nature of data holds the potential for real-time audit and this could result in a shift in function to internal audit from external audit (1994). This issue is considered in more detail in chapter eleven.

A range of views was expressed on precisely what constituted 'operational auditing' (particularly on whether checking of controls related to internal reporting should be treated as operational or financial auditing). In all cases, a substantial part of internal audit work involved the checking of controls and internal audit was regarded as being an effective tool for management control, giving assurances to management that all controls were functioning effectively. One executive chairman, describing the main function of internal audit, said:

*I know it is impossible to guarantee but you can come ... sufficiently close to a control which gives top management the confidence that the company is functioning properly ....* (Company B CE)

The finance director of company A, echoing the thoughts of all executives interviewed said:
I think [internal audit] is the essential tool for control in our organisation. It is taken very seriously, reporting to the chief executive. (Company A PD)

Supervisory boards also relied on assurances given by internal audit on the functioning of controls:

... with larger organisations internal audit concentrates on operational audit ... as a member of the supervisory board I'm happy with that because that is what gives the sense of confidence that enough attention is being paid to how the internal processes and systems are functioning. (Company B SB)

Internal audit saw itself very much as a tool of the parent board - a watchdog to give assurance that management strategies were being followed, that controls were effective and operating and that operational management were effective. It also served to give early warning of problems throughout the company so that these could be addressed at an early stage. One chief internal auditor summed up his function as

... making it possible for the parent board to sleep at night without any problems. (Company C CIA)

Comparison with the ICAS (1993) proposals

ICAS (1993) suggested that, as a pre-requisite for reliance on internal audit by external audit, the professional care and technical competence of the internal audit function must be on a par with external audit. In the companies visited, this appeared to be the case. Even in companies B and C, where internal auditors performed largely operational audit work, external auditors worked closely with them and relied extensively on their work, particularly in obtaining assurances on control effectiveness. This may allay, to some extent, the fear of the incompatibility of audit aims identified in the literature review.

The role played by internal audit and its high profile in the companies were in harmony with the ICAS (1993) proposals that companies should establish and maintain a strong internal audit function under the direction
of a chief internal auditor to provide reassurance to the board of directors
and the audit committee on the reliability and relevance of management
information and control systems.

The reporting lines of the chief internal auditor were also in harmony
with ICAS (1993)'s suggestions that internal audit should report directly
to the chief executive and the FRAC. In the Dutch model, these reporting
lines were also followed, with the added requirement for the audit
committee to report back to the full supervisory board.

The ICAS (1993) proposals envisaged that internal audit would
perform the greater part of the financial auditing work with the 'external
assessor' reviewing internal audit files, reports and conclusions. This
emphasis on financial auditing may not be perceived by directors as an
effective use of finite internal audit resources, since they rely on assurance
from internal audit on wider control, risk management and effectiveness
issues. An 'external assessor', however, would presumably spend less time
than the present external auditor and the resultant savings could provide
room for expansion of the internal audit function to cover such financial
audit work.

The extent to which the 'routine system' data would form the basis
for the annual financial statements would vary from one company to
another, but it is likely to be substantial in most cases. Given the increasing
reliability of the basic accounting data produced by modern computer
systems, such an approach may be appropriate across a wide range of
organisations.

As some interviewees suggested, with increasing integration of
computer systems and the blurring of distinction between 'financial' and
'other' controls, it was likely that external auditors would have to address
the effectiveness of all control systems. There are calls for external auditors
to give greater assurance to management and accounts users on the
company's treatment of a wide range of risks, uncertainties and estimates,
which may require reliance on internal audit or control self-assessment
systems. Indeed, external auditors are responding to these calls by
increasingly moving away from the traditional narrow 'accounting lens'
focus of risk, to a more holistic business risk approach that focuses the
auditor's assessment of risk through a broader strategic-systems lens (see,
for example, Bell et al, 1997). Such a significant change in perspective
may increase the extent of outsourcing of internal audit to external auditors as the need for continuous auditing grows and the boundary between internal and external audit becomes more fluid. This issue is addressed in chapter eleven.

The three-level control model described by the chief internal auditor of company C implies more of an 'assessor' role for the external auditor, as ICAS (1993) suggested. The chief internal auditor concerned, describing that system said:

... the third level (of review of internal controls) is the external auditor (and I like the expression of the Scottish Institute) who is assessing that it is working ... I think when you look at the accounts of our company about 95% of the data comes from routine systems and for those an assessment should be possible. And then you have provisions and other such things to discuss in more detail at the end of the year.

(Company C CIA)

**Supervisory boards**

The Dutch supervisory board has the primary responsibility of supervising management rather than the audit function, although an effective internal and external audit function is a major support to the supervisory board in fulfilling its duties. The supervisory board members interviewed did see themselves as having this wider 'public interest' role. For example, the chairman of one supervisory board observed:

_The supervisory board sees itself as working on behalf of all stakeholders - shareholders, employees, suppliers and customers, the public in general... We liaise with all of these and try to make sure that the company is 'being a good citizen'. (Company C SB)_

Supervisory boards do not exist in the Anglo-Saxon corporate governance model and there has been a great deal of discussion in the UK and on the continent on the perceived advantages or disadvantages of the two-tier board system. This section first presents interviewees' views on the relative merits of the two-tier board system.
Views on the two-tier board system

Among interviewees there was, perhaps unsurprisingly, unanimous preference for the Dutch two-tier board system over the UK's single-tier board. Some of those interviewed had experience as directors of UK or US companies and thought that the two-tier system made a clear distinction between management and supervision and that:

*the clear distinction between these responsibilities is the best thing that a company can have.* (Company C SB)

One chief executive observed:

*The supervisory board is a body with its own responsibilities ... therefore, at critical moments it can act independently - for example firing the chairman of the executive board is within its powers. In the one-tier board at least formally speaking there is too much power in the hands of the CEO.* (Company C CE).

UK-style non-executives, it was argued, were in an ambiguous position, with the same statutory responsibilities as executives. They, therefore, tended to become too involved in the day-to-day activities, attending all board meetings and becoming more of an executive than a non-executive. There was a view that they received too much paperwork and could not possibly exercise any restraint on executives. For example, one director commented:

*Non-executives are too close to the day-to-day business and the risk of their interference in management is too great, in my experience. I think it creates an uncertainty and lack of total clarity of who is responsible for what.* (Company B CE)

The remoteness of the supervisory board from the detailed running of the business was considered to be an advantage since they could stand back and take an overall view of current developments, major business risks and controls in place to manage these risks. One chief executive summed up the situation:
We have a system of the board of management running the company and the supervisory board not co-managing the company but sitting with their eyes and ears open and their brains alert ... Then you have the best of both worlds. You have professionals who are close to the business and who are exclusively responsible for what is going on in the management of the company and some other experienced, capable professionals with all sorts of backgrounds, who are supervising you and have the credibility to do so. (Company B CE)

It was acknowledged that for the two-tier system to work there must be a completely open relationship between the management and supervisory boards. In the cultural environment of the Netherlands, with its emphasis on consensus rather than confrontation, the system was believed to work well.

The suggestion that two-tier boards were unwieldy and inflexible was refuted. Good preparation and anticipation were thought to be the key to avoiding this. For example:

If we take decisions that need the approval of the supervisory board then you know in advance that kind of decision will come ... If you plan well ahead then this system is as flexible as the one-tier system as long as the supervisory board is always prepared to be called into special meetings. (Company B CE)

Although ICAS (1993) did not suggest the introduction of a two-tier system in the UK, the proposed ARP has some functional similarities to the Dutch supervisory board.

Functions and responsibilities

The companies confirmed that supervisory boards existed to supervise management and to act as a sounding board for management ideas. In addition, they had a responsibility to give them advice - whether requested or otherwise, where appropriate. Supervisory board members interviewed saw themselves as actively supervising the executives rather than passively offering advice when asked. The position of the supervisory board, in theory, places management in the position of justifying proposals
and strategies to a group of independent, knowledgeable individuals operating within the company. It was argued that this improved the quality of executive decisions. For example, one finance director said:

_We sometimes come up with proposals which they think are absolutely incomprehensible, and then we have to make it quite clear why we think the particular matter is important._ (Company A FD)

Supervisory boards also had the power to appoint and remove executives and were involved in management development and succession issues. They approved the half-year and annual accounts, all investments over a certain level and (in one company interviewed) press bulletins and long-term plans. Executive and supervisory board members interviewed believed that these individuals were, therefore, in a position to exercise considerable influence over a company’s activities. Powerful sanctions were available to them in dealing with problems in the executive board and in ensuring that the appropriate balance of expertise and experience was maintained. One director observed:

_We always feel that our supervisory board stands back from the business and they would like to know what is going on. So they ask detailed questions. It keeps the board itself sharp. They have to come up with arguments for their proposals .... It is very important that you always have to explain to another body what you are doing and why ... especially when you feel on the other side of the table there are people who are in the same business and understand your problems. Then you can talk on the same level._ (Company A FD)

Supervisory board members interviewed stated that they carried out their work for the benefit of all the stakeholders in the company, not simply the shareholders. A wider public interest dimension was also recognised and it was regarded as important to ensure as far as possible that the company behaved as ‘responsible citizens’ in the community. The unanimity of this view was interesting because the literature review noted that some writers have suggested that the supervisory board could become a vehicle for the operationalising of contemporary concerns about the ‘stakeholder society’.
Operations

Membership of supervisory boards in the companies was varied and included former executives, prominent businessmen and other individuals with recognised expertise in particular aspects of the company’s business. The aim was to produce a balance of skills to ensure effective supervision of the company’s activities. One chief executive remarked:

I am in favour of having at least one of the former CEO’s in the supervisory board because he has detailed knowledge of the company, where the critical, more risky, more sensitive parts are, so he can ask the right questions at the right moments. (Company B CE)

Formal supervisory board meetings in the companies visited took place six to seven times per annum, and executive directors were also present. At these meetings, the executive chairman reported to the supervisory board and a substantial volume of financial and other documentation was made available to them. The report of the audit committee was examined in detail and other issues discussed at board meetings included acquisitions, economic and legal developments and strategic matters. Formal meetings, however, were not the only contacts between supervisory board members and executives. One supervisory board member stated:

We are well informed and apart from the official meetings there are unofficial meetings and contact by telephone to inform us beforehand that there will be an issue coming up at the next meeting so that we can start thinking about it, asking for information or giving advice. (Company C SB)

Supervisory boards were self appointing and this co-option system was, on the whole, considered to be satisfactory by executives and supervisory board members in all the companies. It was believed that board members were best able to decide which expertise and personalities were needed to maintain a balanced supervisory board. A suggestion was made that shareholders should appoint the supervisory board but the consensus view was that this would probably not be effective. The co-
option system was the most appropriate, and it actually protected the independence of the supervisory board. Although the danger of the co-option system creating a tight and exclusive 'old boys' network was recognised by the interviewees, it was not considered to be a problem. One chief executive commented:

*I see the possible risk of a supervisory board which invites friends or others that they like .... This is not the case in this company and I am pretty positive it is not the case in corporate Netherlands .... If [the appointments] are not properly done you will immediately have criticism in the press.* (Company B CE)

Comparison with the ICAS (1993) proposals

The ICAS (1993) proposals did not advocate a two-tier board system and the major functions of the supervisory board *vis-à-vis* the directors had no place in the ICAS (1993) structure. There are, however, parallels between some aspects of the Dutch supervisory board and the proposals for the ARP mooted by ICAS (1993) eg the presence of independent individuals within the company, with expertise in the company's business, overseeing the audit function. The ARP, like the supervisory board, would be self appointing and would act in the interests not only of the shareholders but also of the other stakeholders. It would also provide a vehicle for widening the accountability of companies. Further, it was envisaged that the ARP, like the supervisory board, would report to shareholders in the company's annual report. Although supervisory boards and ARPs are not identical in their functions and responsibilities, there are sufficient parallels to suggest that the way the supervisory boards and Dutch audit committees function gives some idea as to how an ARP might operate.

ICAS (1993) envisaged a somewhat restricted role for the ARP, suggesting that it could be involved in the appointment of external assessors and fixing their remuneration in consultation with the board. The ARP would act as an escape route for the external assessor in the event of a conflict with executive management. It would, however, not be
inconsistent with the ICAS (1993) proposals to suggest a more proactive role for the panel in monitoring the effectiveness of external audit on behalf of all stakeholders.

Under the ICAS (1993) proposals, the responsibility for audit supervision would be split with the FRAC supervising internal audit and the ARP supervising external audit. However, although the primary work of the ARP would be in relation to external audit, ICAS (1993) did suggest that any problems with the working of internal audit should be reported to the ARP, thus providing a link between the ARP and both audit functions. This link could become increasingly important in the event of a greater synthesis of the work of internal and external audit.

In the Dutch model, the connection between the supervision of both audit functions was maintained by the supervisory board overseeing both the internal and the external audit function through the audit committee operating as a sub-committee of the full supervisory board. In contrast it was interesting to note that supervisory board members interviewed were reluctant to assume even the level of responsibility envisaged by ICAS (1993) for the assessment of external audit effectiveness, since their main function was the supervision of the executive directors rather than the external auditors.

Summary

The key similarities and differences between the functions and responsibilities of each Dutch internal monitoring body and those proposed by ICAS (1993) are summarised here.

Audit committees

In comparing the findings from the fieldwork with the ICAS (1993) proposals one similarity and two differences were identified.
Similarity

- The Dutch audit committee, like the FRAC, relied on internal audit to provide it with assurance that management information systems and internal control systems were adequate and operating satisfactory.

Differences

- The primary function of the Dutch audit committee was to supervise the activities of directors and the company while that of the FRAC would be to provide directors with reassurances on financial reporting and auditing matters.

- There was possibly greater detachment, and hence independence, of Dutch audit committee members from executives than would be the case for FRAC members.

Internal audit

In comparing the findings from the fieldwork with the ICAS (1993) proposals four similarities but no differences were identified.

Similarities

- The ICAS proposals like the Dutch position relied on internal auditors whose abilities and status are on a par with external auditors.

- The role played by Dutch internal audit and its high profile were in harmony with the ICAS (1993) proposals to establish a strong internal audit function.

- The reporting lines of internal audit were also in harmony with the ICAS (1993) proposals to report to the chief executive and the audit committee/FRAC.
- The shift of detailed financial audit work from the external to the internal auditor would leave the external auditor with an assessor role.

**Supervisory boards**

In comparing the findings from the fieldwork with the ICAS (1993) proposals the following two similarities and three differences were identified.

**Similarities**

- Like the supervisory board, the ARP would act in the wider public interest.
- Also like the supervisory board, the ARP would report to the shareholders in the company's annual report.

**Differences**

- The ICAS (1993) proposals do not advocate a two-tier board system, as exists in the Netherlands.
- The supervisory board has a broader responsibility for financial audit matters than that envisaged for the ARP.
- The supervisory board has responsibilities in relation to both internal and external audit, while this responsibility is limited to external audit for the ICAS (1993) monitoring bodies (ie ARP and FRAC).

Discussion of the implications of these similarities and differences for the desirability and feasibility of the ICAS proposals is deferred to chapter eleven. The three internal monitoring bodies do not operate in isolation, however, and their interactions are discussed in the next chapter.
CHAPTER NINE

INTERFACES BETWEEN DUTCH MONITORING BODIES AND BOARD OF MANAGEMENT

This chapter examines the inter-relationships between the three internal monitoring bodies, with the audit committee being discussed within the context of the supervisory board as a whole. It also considers the interfaces between the internal monitoring bodies and the external auditors on the one hand and the board of management on the other. The focus of the project is internal monitoring bodies, therefore, the relationship between the board of management and external audit is not considered here.

Five principal interfaces are, therefore, considered: internal audit and supervisory board; internal audit and external audit; supervisory board and external audit; internal audit and board of management; and supervisory board and board of management. At the end of the five main sections, there is a comparison between the fieldwork findings and the ICAS (1993) proposals. Inevitably, the similarities and differences identified here overlap with those identified in chapter eight.

Internal audit and supervisory board

This section considers separately internal audit contact via the audit committee and direct contact with the supervisory board.

Contact via the audit committee

Internal audit usually dealt with the supervisory board through the audit committee. One chief executive explained:
Direct contact

In the companies visited, direct contact between the internal auditor and the supervisory board was minimal. This was consistent with the Dutch literature. Most interviewees believed it was unnecessary to increase this. The view was, however, expressed that, in the event of problems with internal audit (especially where there was doubt as to its independence), supervisory boards would probably want to increase their involvement. One chief executive commented:

*I think that the supervisory boards must be satisfied with the quality and the independence of the internal auditor. If they have doubts then it might be a point on the agenda between the supervisory board and the board of management that they want to have direct contact.*

(Company B CE)

Direct contact between supervisory boards and internal audit would be at the instigation of the supervisory board. Members of management were always present at audit committee meetings and there were no formal procedures for internal audit to meet with the audit committee/supervisory board without the presence of management. In discussions with internal auditors, executives and supervisory board members, there was no enthusiasm for independent meetings with supervisory boards instigated by internal audit. It was believed that this would indicate problems in management, and the suggestion provoked a great deal of unease. One chief executive, speaking hypothetically, commented:

*I think the contact (with the supervisory board) should remain through me. And if it is an issue where the internal auditor is convinced it should be brought to the attention of the supervisory board, then it is his job to convince me to do that. And if I don't think it should be brought to the supervisory board, for whatever reason, we would have a problem then. But that is a totally extreme and totally theoretical situation.*

(Company B CE)
His internal auditor agreed that it would be an extreme situation, but that he had written authority to contact the supervisory board directly should the need arise.

_In my function as chief internal auditor it is written down that if I feel it is necessary I can approach the chairman of the supervisory board. As you can understand I will never do that in normal circumstances. The only reason to go to the supervisory board would be that the chairman of the management board is not listening to me as he should._ (Company B CIA)

In company A, however, the chief internal auditor was less positive about his ability to approach the supervisory board in the event of a problem.

_So far there are no formal possibilities for me to have access to the supervisory board. I report to the president of the board of management - end of story. In Dutch philosophy there is no possibility for me to address the supervisory board. A big change would be needed in Dutch thinking to bypass the board of management._ (Company A CIA)

In the event of an insurmountable problem, he thought that his 'escape route’ would be to the external auditor. In the other companies interviewed, supervisory board members made it clear that, in extreme cases, they would expect internal auditors to approach them directly, either through the audit committee or some other way, but only after informing management that they were going to do so. Executive directors had mixed views on whether this was permissible. One finance director, however, thought that internal auditors should have this facility for use in an emergency:

_I would say through management. Internal audit reports to the president, and I think the president would be really hurt if it went to the audit committee directly. But in a case where there is something very serious which the president would not allow to be reported then I think internal audit should go direct to the audit committee. In theory you can make nice reporting lines but in practice it is more difficult. It depends on the_
integrity of the persons involved. But I think it would be very bad if
the internal auditor communicated directly bypassing the president.
(Company C FD)

It was interesting that interviewees were reluctant to have
independent contact in normal circumstances. It was argued that this
was cultural rather than a reflection of the desire of executives to exercise
control. The principal reason for the reluctance was the potential damage
to the harmonious working relationships within the company. In any
case, it was argued, internal auditors were given freedom to report concerns
and opinions even where they disagreed with the views of management.
In this way, the supervisory board was informed of all shades of opinion.

Comparison with ICAS (1993) proposals

In the UK, the Cadbury Report and the IIA, advocated that the
audit committee should have the dual role of monitoring the plans and
performance of internal audit, and of maintaining the status and resources
of internal audit within the organisation. Recent literature has noted
that internal auditor-related motives were a major driving force for
operating an audit committee. ICAS (1993) also proposed a close
relationship between the two, with the chief internal auditor reporting
to the FRAC. Indeed, ICAS (1993) considered that the FRAC would
only be able to fulfil its responsibilities if a strong, independent internal
audit function was to report to the committee. However, ICAS (1993)
also proposed a split between the FRAC and the ARP. This separation
does not exist in the Dutch model and the effect that this would have on
audit committee/FRAC effectiveness requires to be addressed.

ICAS (1993) believed that the FRAC should be able to support the
independence of internal audit within the organisation. In the Dutch
model also, there was an opportunity in extremis for internal audit to
approach the audit committee/supervisory board directly. This ‘protector
role’ for the supervisory board was akin to that suggested by ICAS (1993)
for the ARP, which, although primarily having responsibility for the
external assessment function, should be informed of problems in internal
audit. The ARP, consisting of independent officials, could arguably take a stronger line than the FRAC in defending internal audit from management interference.

It was not clear, however, how effective this would be in practice. The internal auditor of company A said that his first ‘escape route’ in the event of a problem with management would be to the external auditor rather than to the supervisory board. This could, of course, be a reflection of the more distant relationship between supervisory board and internal audit in that company.

In the Netherlands, also, the supervisory board, with its need for reassurance on control effectiveness, might be expected to work closely with internal audit. It was, therefore, surprising to note the limited contact between the supervisory board and internal audit. Supervisory board members in companies B and C expressed the need to have confidence that control processes were adequate in practice, and relied largely on a strong internal audit function to assure them of this. It was, therefore, surprising that there were not more frequent meetings. In company B, the audit committee as such met twice during the year and in company C there were only four meetings. When asked if this was enough the chief executive replied:

Ample. It errs on the side of ‘too many’ rather than ‘not enough’.
(Company C CE)

Supervisory board members, while believing that their contacts with internal audit were adequate for their purposes, indicated that if they had doubts about internal audit efficiency, then they would become more involved in the audit process, particularly in planning. It was significant that even in company C, which had the largest number of annual meetings between audit committee and internal audit, there was a view that the primary duty to oversee the effectiveness of internal audit lay with management. This situation has implications for the effectiveness of both supervisory boards and internal audit, and is discussed in chapter ten.
Internal and external audit

The level of co-operation between internal and external audit is extremely important, as this relationship is essential to the ICAS (1993) proposals. The relationship between the two sets of auditors was also an important part of the corporate governance model in the companies visited. This issue was of particular interest in the companies interviewed because of the difference in emphasis between internal audit in company A compared to companies B and C. The perceived benefits to the overall audit function of the close co-operation are also discussed in the next section.

Internal and external auditors in all the companies interacted for co-operation and the mutual supply of information. There was, however, also an element of mutual monitoring of quality, with both sets of auditors being expected to report to audit committees/supervisory boards and to executive management if they had doubts about one another's quality. The view was expressed that, because of the extent to which the auditors relied on one another, both would have an incentive to declare doubts about the other's quality.

Level of co-operation

In the companies co-operation between internal and external auditors was much closer than is generally the case in the UK. It was apparent from discussions with directors and internal auditors that both sets of auditors were considered to be on a par regarding qualifications and work standards. This situation was confirmed in informal discussions with external auditors.

ICAS (1993) suggested a number of attributes for internal audit which would ensure their effectiveness and relevance to the extent that external assessors could rely substantially on their work. These included the exercise of due professional care, technical competence, possession of adequate resources and the transmission of internal audit reports to the external auditors. Interviewees were confident that their internal audit functions possessed these attributes.
For example, in company A internal audit performed largely financial audit work and generally tried to act as a 'clone' of external audit. In this case, the auditors co-operated extensively at the planning stage to discuss programmes and approach. After the internal audit work was completed, working papers were reviewed by the external auditors, outcomes were discussed, conclusions were drawn and any additional work required was carried out. Internal audit in this group internally certified the annual accounts of all Dutch group companies, so the work on the financial accounts paralleled more closely the normal work area of an external auditor. In addition, when internal audit was engaged in control testing, site visits and project appraisal, external auditors relied extensively on their detailed work and there was close co-operation on a worldwide basis.

In companies B and C, where the internal audit emphasis was more on operational work, there was still substantial co-operation, although the roles were different. The external auditor's responsibility was to report on the annual accounts. The internal auditor concentrated on procedures and controls; whether they existed; and whether they functioned. It was argued that since the statutory accounts information was a product of these systems, the external auditor had an interest in their effectiveness. One internal auditor summed up the situation as follows:

*It is essential that the external auditor is able to form an opinion on the set up of the administrative organisation and information systems (including internal controls) so that he can rely on the information generated by the system in his audit of the financial statements. In this respect, the external auditor can rely to a large degree on the results of internal audit work. The goal must be to co-ordinate and harmonise the work performed by the group internal auditor and the external auditor so that there are few if any overlaps and duplications and the audit as a whole is cost effective.* (Company B CIA)

His chief executive commented:
... under the present system it would not really be possible for the external auditors to give a clean bill of health to this company if they could not rely on the quality job done by a relatively independent internal audit function. Otherwise they would have to go a lot deeper into the organisation. (Company B CE)

Perceived benefits of co-operation

Four major benefits were perceived to accrue from this detailed co-operation: company-specific expertise to assist the external auditor; cost-effectiveness; mutual support; and enhancement of independence.

Company-specific expertise to assist external auditor

There was seen to be an inherent danger that external auditors could lack expertise in the company's business, and internal audit was thought to help the external auditor to target the high-risk areas more effectively. One chief executive observed:

... certainly for the more sophisticated, more professional part of the company ... state of the art systems and ... very complicated work, I think it is logical for the external auditors to rely to a great extent on the expertise of the internal auditors. They are always ahead of the external auditors because they are simply closer to the business. (Company B CE)

In company C, also, it was thought that lack of external auditor expertise to comment on internal control systems would increasingly become a problem because of the integration of systems:

... because of EDP and integration between business processes it's much harder for external auditors to understand and follow the flow of information. (Company C FD)

One chief internal auditor thought that internal auditor expertise could not only be relied on by the external auditor but could be used to guide him in his work:
I am very much in favour of a discussion of the audit approach by the external and internal auditor because the internal auditor can ensure that the programme takes the peculiarities of the company sufficiently into account. He will also try to protect the company from an overdoing of the audit. (Company C CIA)

The obvious danger was for the internal auditor to have undue influence on the level and nature of external audit work, although the interviewees believed that (at least in their own companies) the external auditor would have the final say on the work carried out.

Such a level of reliance also meant that there was detailed discussion at the planning stage, where work levels and approaches were dovetailed together. External audit reviewed internal audit plans and programmes, suggesting amendments where appropriate. Thereafter, there was regular liaison between the two sets of auditors at different levels to review agreements, workloads and developments and the results of internal audit work were communicated to the external auditor. At the end of the audit, internal audit files were reviewed in detail by the external auditor:

*We have contact as internal auditors with the external auditors abroad and we discuss the outcome of all audit issues. Also, we have combined closing meetings with local management to discuss all issues from the audits.* (Company A CIA)

Cost-effectiveness

The chief internal auditor in company C expressed the opinion that it was not cost-effective for external auditors to become involved in detailed system reviews. This should be left to the internal auditor, with the external auditor testing 'in a limited way.' The external auditor would thereby be largely fulfilling ICAS (1993)'s 'assessor' role.

In company A, the close working of the two sets of auditors meant that external audit carried out no fieldwork at all.

*We discuss our audit programmes with our external auditors and all our files can be reviewed by our external auditors, and we prepare ... summaries of findings and they are discussed with the external auditors,*
but they do not do any fieldwork. Our external auditors come in here, into this building, get our files and work programmes and we discuss the outcome of our audit. I think this is a unique situation in Holland. They do no fieldwork at all. (Company A CIA)

One chief executive commented:

*There is a very logical division of labour - who does what. That makes it an effective but also efficient way of doing the overall audit.* (Company B CE)

**Mutual support**

From discussions it was apparent that internal and external auditors worked closely together. Both attended audit committee meetings, presenting what appeared to be a united front. Internal and external auditors submitted management letters (in some cases jointly) and these were discussed with the management and supervisory boards. The matters covered at these joint meetings included preparations for the annual accounts, discussions on interim reporting and management letters and the effectiveness of corporate governance within the group. The outcomes of audits and systems reviews at subsidiary level were also discussed jointly with local management.

**Enhancement of independence**

Such extensive co-operation, if effective, could strengthen the position of both sets of auditors, and this was suggested in all the companies. The existence of external audit was considered to strengthen the independence of internal audit. External auditors also could find their approach more focused as a result of close liaison with internal audit. One chief executive stated:

*I think it is a very good system. It allows the total independence of external audit to continue but it also creates and supports the independent position of internal audit.* (Company B CE).
Comparison with ICAS (1993) proposals

The relationship between internal and external auditors in the companies visited constituted the strongest parallel between the Dutch system and the ICAS (1993) proposals. In the companies the close working relationship was designed to produce an overall audit effort that was as effective as possible. In company A, where the internal audit work was primarily financial in nature, internal audit coverage of worldwide activities was in greater depth than external auditors would find practical in the time available to them. In addition, their knowledge of individual projects meant that they could give comfort to the external auditors on the adequacy of provisions and other problem areas. In companies B and C, where internal audit work was mainly operational, work was directed to both financial and operational controls. As integrated control systems were in operation, this gave considerable assurance to the external auditors on the validity of the accounting data produced by these systems. Both companies expressed doubt that external auditors would have the expertise to assess these systems.

In the three companies, internal audit's detailed working knowledge of the company's business was also thought to improve the quality of the overall audit effort. It was argued that risk analysis and problem identification were more focused than if external auditors alone had been involved in the exercise. It could also offer greater assurance that opportunities for fraud and other illegal acts had been minimised.

There are moves, however, to introduce a major change in the frame of reference of external audit. This involves a move away from the old approach of a set of yearly financial statements accompanied by an annual audit report to a new audit framework of a set of real-time financial and non-financial information accompanied by continuous assurance to client directors and shareholders and possibly the public (AICPA, 1998). This is an attempt by the large accountancy firms to re-orientate the audit around the processes that constitute the client's (ie the directors') own view of the business (Ashton, 1998). This shift would, over time, result in continuous auditing and involve auditors in providing more assurance on 'tough problems' such as detecting fraud and illegal acts, providing early
warning of financial distress and going concern issues, and dealing with risks, uncertainties and estimates (AICPA, 1998). Such an approach would increase internal and external auditor co-operation, but could also result in an increase in outsourcing of internal audit work to the external auditor.

Although internal and external auditors in the companies worked closely together, there was a difference in their objectives since internal audit were providing assurance to management, whereas external audit were reporting to shareholders. This raised the question of internal audit independence from top management. ICAS (1993) attempted to enhance internal audit independence by proposing that it should report to the FRAC as well as the chief executive. In companies B and C, internal audit did meet with the audit committee/supervisory board, but whether the audit committee could be relied upon to protect internal audit to the extent envisaged by ICAS (1993) depends on the effectiveness of both internal audit and the supervisory board (see chapter ten). The effectiveness of the supervisory board, in turn, depends on its relationship with the management board (considered later in the chapter). If the supervisory board is not independent of the executives, then it is unlikely that it will be able to take effective action in support of internal audit.

**Supervisory board and external audit**

Interaction between the supervisory board and external audit was mainly for the purpose of supplying the supervisory board with information on financial reporting matters and management letter issues, and to give the supervisory board the opportunity to monitor external audit quality. Meetings between the two were not frequent. Supervisory board members interviewed did indicate an interest in external audit results and a duty to have a view of external auditor effectiveness, but external audit involvement with the supervisory board tended to be through the audit committee. Interviewees did not perceive the audit committee as a buffer between the external auditor and executive management, as they did not see the need for such a function. The view was expressed by one chief executive that if the external auditor's independence were compromised to that extent, the management board
would want to change auditors anyway. One internal auditor, however, thought that the external auditor might find his position strengthened if there was more contact.

Both external and internal auditors attended audit committee meetings, and, in two of the companies presented joint management letters to the committee (in the presence of management). At these meetings, auditor evaluation of controls was also discussed, in addition to the annual and half-yearly accounts (in companies B and C) and any issues arising from the audit. Both sets of auditors were given opportunities at such meetings to intimate any problems they had encountered in their work.

The external auditor is always present at the meetings in which the supervisory board is asked to approve the final dividend and the annual accounts ... but the preparatory work has been done already in other meetings. Four times a year there is an opportunity for the auditors to make clear if they are happy with whatever it is and answer questions asked by members of the committee. (Company C SB)

The chief internal auditor in company A indicated that, in his company, the external auditor took the lead in the meeting with the supervisory board.

As with internal auditors, supervisory board members considered that, in the event of a problem, external auditors could approach them directly. In addition, the supervisory board members confirmed that if the company was experiencing problems, then they would become more involved with the external auditors.

Comparison with ICAS (1993) proposals

ICAS (1993)'s ARP would have responsibility for supervision of the assessment process on behalf of the shareholders, while being responsive to the needs of other stakeholders. This differs from the Dutch supervisory board whose primary supervisory role is in relation to the management board. The supervisory boards in the companies interviewed did have an interest in auditor effectiveness and relied on their own work through
the audit committees and the reports of internal audit, to assess external auditor effectiveness. However, the approach tended to be reactive to issues identified rather than rigorous in seeking out problems, although this may be due to the lack of financial and operational problems in the companies. One would therefore expect that the ARP could exercise closer control over the planning of the audit, its execution and results since that is its major function. By doing so, it could offer greater assurance to stakeholders on the integrity of the external assessment process.

ICAS (1993) also proposed a more prominent role for the ARP in the appointment and removal of the external auditors and in allocating non-audit work to them than that exercised by supervisory boards. Supervisory boards, in the companies interviewed, although having an input to the process tended not to take the lead in such negotiations. Again, such involvement by the ARP could strengthen the position of the external auditors (assessors) and make them more accountable.

In the Dutch model the audit committee operated as a sub-committee of the supervisory board but ICAS (1993) proposed a split between the FRAC (consisting of non-executive directors) and the ARP (consisting of independent outsiders). The FRAC would primarily have responsibility for the internal audit function and the ARP would supervise the external assessment function. These are not entirely divorced from one another, however, since the close liaison between internal auditors and external assessors would ensure that they were notified of problems identified by the former group. In addition, ICAS (1993) provided for any problems in the working of internal audit to be reported to the ARP, either by the external assessors or the FRAC.

**Internal audit and board of management**

The close relationship between the chief executive and chief internal auditor and their regular formal and informal contact was emphasised by interviewees. Regular contact was used to pass information both ways. Of particular relevance is the extent to which management exercised an influence on programming, investigating and reporting by internal audit, because of the potential impact that this would have on independence.
Information flows to management from internal audit

Internal audit was regarded as a major tool for management control and the need for regular liaison was emphasised. In the companies, internal audit reported directly to the chairman of the management board, which enhanced its independence within the organisation. Meetings were held at least on a monthly basis although there might have been other ad hoc meetings. In addition, there was a great deal of informal contact and company C’s chief executive said that he saw the chief internal auditor at least three times a week. Such regular contact was also a feature of the other companies. For example, one internal auditor said:

We have a monthly meeting with the president of the board of management to discuss our findings from the last period. Apart from those, if I think there is something special to report I will give him a memorandum, or just walk in and say I want to discuss something. (Company A CIA)

The main function of meetings was to report on the progress of projects and to discuss internal audit findings to advise management of problems so that corrective action could be taken on a timely basis. More importantly, internal audit gave assurance to management on the effective functioning of controls and the internal auditor’s reports on controls were discussed in detail with the management board.

The quality of middle and lower management and the control systems operated by them were also assessed and reported on as appropriate. One internal auditor described how:

... operational audits consist of independent in-depth investigations and assessments of the quality of management at all company levels. Reports are commonly sent to the auditee and one level up. Very serious findings are reported to higher levels within the organisation. (Company B CIA)

Another chief executive expressed his satisfaction at that situation of local accountability:
The effectiveness of internal audit is at the lower end of the operating companies where the managers review the findings of internal audit. I'm only interested in the headlines and don't need to know the detail. (Company C CE)

The approach in relation to middle and lower management is proactive, considering the implications of findings for the future and the emphasis in relation to management and control is positive. All findings are discussed at subsidiary level first in an attempt to address problems locally as soon as they are identified. Internal auditors see themselves very much as colleagues of subsidiary management rather than as outsiders sent merely to criticise.

The emphasis on control assurance is very strong and internal auditors interviewed (especially in the two departments primarily involved in operational auditing) appeared to regard providing assurance on controls as their primary raison d'être.

**Information flows to internal audit from management**

Information also flows from management to internal audit. Company A's internal auditor explained how he is briefed on a weekly basis on the matters discussed at management meetings.

Of course they don't tell us everything. We don't need to know everything! We will be informed about business information. When I hear rumours that one of our contracts is going badly I can ask my colleagues 'Are we aware of that? When were we there?' So we can do some additional work or we can take our reports and give some information to the board of management. (Company A CIA)

This mutual exchange of information, often on an informal basis, was recognised as being very important. Another internal auditor, identifying topics for meetings included:

... any other items for which an exchange of thoughts would be useful. (Company B CIA)
As a rule, senior management do not have detailed input to internal audit planning, although there is detailed discussion between internal audit and individual company/division management on the areas to be examined. Internal audit plans are the responsibility of the chief internal auditor and management input tends to be limited to advocating minor adjustments or suggesting areas they would like addressed. One chief executive remarked on his role in planning:

*I know plans are discussed with the various divisions and I see them. Sometimes I just take note, because I think it does make sense. Sometimes I come up with a suggestion like 'Why don't you put Morocco higher on the list and Belgium lower?'* (Company B CE)

It was emphasised by both internal auditors and executives in the companies that no attempt was ever made to restrict audit work or to prevent auditors from considering particular areas. Of course, this was set against the background of a situation where executives were satisfied with internal audit performance. If this were not the case, there would likely be more involvement by management.

**Comparison with ICAS (1993) proposals**

The relationship between Dutch internal audit and the board of management is similar to that envisaged by the ICAS (1993) proposals, with emphasis on assurance being given to the board that management information and control systems are reliable and relevant to help the board fulfil its responsibilities and minimise fraud and error.

Internal auditors and executives interviewed were adamant that internal audit operated independently and without management interference, although senior management had the ability to restrict internal audit activity if desired. The chief internal auditor in company C observed:

*I am independent because my management wants me to be independent.*

(Company C CIA)
ICAS (1993) sought to balance the need for internal audit independence and the need for executives to supervise and control internal audit by suggesting a close working relationship between internal audit and the FRAC. In the event of a problem, the ARP would also be on hand to support the internal auditors. The parallel relationship in the Dutch model is that with the audit committee and, through it, the supervisory board. The ability of internal audit to operate independently is influenced by the independence and influence of the supervisory board within the organisation. The relationship between the supervisory board and the board of management is, therefore, also critical.

**Supervisory board and board of management**

Regular formal and informal contact between the two boards is important to enable effective supervision to take place. As expected, given the function of the supervisory board, there was regular contact between the two boards. Formal meetings were generally held six to seven times per annum and at other times there were informal meetings, and conversations, to ensure that supervisory boards were kept informed of developments as they arose and to prepare them for decisions that had to be made. Such forward thinking was regarded as essential if the twotier system was to operate effectively. Management was always present at supervisory board meetings, although in company B at least, there was a minimum of one private meeting of the supervisory board each year to consider board composition. Although the co-option system existed, the appointment of new supervisory board members was generally reached by consensus with the management board.

In addition, supervisory board members had periodic contact with directors and management of group companies worldwide, who made presentations on their activities. Supervisory board members were thereby given the opportunity to compare what they hear locally with the information supplied at parent board level.
A great deal of detailed information was made available to supervisory boards. Financial matters were discussed in detail in the audit committee and reported to the full supervisory board. One chief internal auditor remarked that the supervisory board received:

... quite broad information - all budgets, for example, in detail and management reports. You can tell when you listen to their questions that they have studied it. (Company C CIA)

There was, of course, the risk that sensitive matters were concealed from the supervisory board. This risk was recognised and executives interviewed stressed the importance of having an open relationship with the supervisory board. Supervisory board members were not present all the time and in a complex organisation there had to be reliance on management to produce information, especially when there were developments of which the supervisory board was unaware. Interviewees were of the opinion that, however, if management once failed to provide information the good relationship with the supervisory board would be destroyed and they would thereafter take a much closer involvement in company affairs.

Even if the company was experiencing problems, there was confidence that this open relationship would continue. One internal auditor stated:

This is a no-nonsense company and nobody is really hiding information. I can't say communication is perfect within the company because everyone is busy and things are not always easy. But I don't think in difficult circumstances that the executive board would provide the supervisory board or the audit committee with less information (Company C CIA).

It was argued that it was not a 'cosy' relationship between equals. One finance director, discussing the composition of the supervisory board summed up:

... those people are in the limelight. They are very involved in reporting, reporting needs, in corporate governance, in industrial relations .... . While we know these people they are certainly not close friends of ours.
There is a hierarchy difference and they usually sit on the board for more than eight years ... people who are eight years on the board of this company know very well what is going on. (Company A FD)

Comparison with ICAS (1993) proposals

ICAS (1993)'s ARP would tend to be smaller than the supervisory board, being limited to three individuals. It would have no responsibility for the functioning of the directors. Instead, it would concentrate on the supervision of the external assessment process. Like the supervisory board, ARP members would be independent of the directors. Most ARP functions would be in relation to the external assessors, e.g. receiving reports from assessors on their work, appointing the assessors and fixing their remuneration, approving or requesting non-audit work to be performed by assessors and counselling the assessors if there is suspicion that directors are involved in fraud. The supervisory board appeared, in practice, to take a secondary role in this, with the directors in effect making the final decisions.

As a result of their different roles, ARP contact with the directors would be less in any case and the ICAS (1993) proposals have little to say about the relationship of the ARP to the directors. The ARP would not be directly concerned with business operations and it can be inferred that it would be more remote from the running of the company than the supervisory board.

Summary

The similarities and differences between the relationships between the internal monitoring bodies and the board of management in the companies and those proposed by ICAS (1993) are summarised here.
Internal audit and supervisory board

In comparing the findings from the fieldwork with the ICAS (1993) proposals the following three similarities and four differences were identified.

Similarities

- The audit committee, like the FRAC, had an interest in ensuring that the company maintained a strong, independent internal audit function, and monitored internal audit performance to satisfy itself that this was the case.

- The audit committee relied on internal audit for assurance on control effectiveness throughout the company.

- In the hypothetical situation where problems arose between internal audit and executive management, the opportunity existed for internal audit to approach the audit committee directly, for support. Although doubt was expressed as to whether this was a realistic expectation, it was argued that, in an extreme case, the supervisory board, through the audit committee, could take on the role of protector of internal audit. This protector role was similar to that proposed by ICAS (1993) for the ARP, who would be informed of any problems with internal audit independence and effectiveness.

Differences

- In the Dutch model, there was no separation between the audit committee and the supervisory board, with the committee operating as a sub-committee of the board, and having an interest in both internal and external audit functions. In the ICAS (1993) model, the FRAC, consisting of non-executive directors, would have responsibility for internal audit, while the ARP, consisting of independent officials, would oversee the external assessment function.
- The Dutch audit committee's primary role was the facilitation of the supervisory board's work in supervising management, and their interest in internal audit effectiveness was a means towards that end. The view expressed was that it was management's responsibility to supervise internal audit effectiveness. The FRAC, however, would have the primary responsibility of supervising internal audit.

- The audit committee had little involvement in internal audit plans, although it was pointed out that this situation had to be considered against the background of highly efficient internal auditors. The FRAC, however, would expect to be more involved in internal audit plans.

- Although the audit committee had an interest in maintaining internal audit quality, the FRAC would have a stronger role in that area, for example, by ensuring that internal audit was adequately resourced and given appropriate status within the company.

**Internal and external audit**

In comparing the fieldwork findings and the ICAS (1993) proposals the following two similarities and one difference were identified.

**Similarities**

- The existence of a strong internal audit function which was perceived to be as technically competent as external audit, co-operating with the external auditors to maximise cost effectiveness and provide mutual support was a close parallel between the system in the Dutch companies and that proposed by ICAS (1993).

- The high level of reliance by external auditors on internal audit for the performance of financial audit work.
difference

- The emphasis on operational audit work by Dutch internal audit was at variance with the ICAS (1993) proposals for internal audit to perform much of the detailed financial audit work. (The trend in external audit towards providing continuous assurance on business risk and problems, and on the validity of real-time financial data may, however, create a greater synthesis of internal and external audit).

Supervisory board and external audit

The comparison of fieldwork findings and the ICAS (1993) proposals identified the following two similarities and three differences.

Similarities

- The Dutch model has a similarity to the ICAS (1993) proposals to set up a group of independent officials, with knowledge of the company’s business, within the organisation, and gave them a duty to satisfy themselves as to the effectiveness of the external audit (assessment) function. This additional layer of control in the companies gave the external auditor the opportunity to raise any issues of concern.

- The supervisory board gave the opportunity for independent input to the external auditor selection process by individuals who had a duty to act on behalf of all stakeholders.

Differences

- The major difference between the supervisory board and the ARP was in their primary responsibility. The supervisory board’s responsibility was to supervise the board of management whereas the ARP’s duty was the supervision of the assessment process on behalf of the shareholders and in response to the needs of other
stakeholders. This means that the supervisory board's dealings with external auditors tended to be more reactive than the ARP's dealings would be, since supervision of the assessment process is the latter's raison d'être rather than a means to an end.

- This difference in primary function also meant that the supervisory board played only a supporting role in appointing or removing the external auditors, fixing their remuneration and in deciding on the level of non-audit work to be given to them. The ARP would have a leading role to play in these areas.

- The other major difference lay in the separation in the ICAS (1993) proposals between the FRAC (consisting of non-executive directors) and the ARP (consisting of independent individuals with no links to the company). In the Dutch companies, the audit committee was a sub-committee of the supervisory board. Dutch interviewees suggested that their audit committees could be more independent than the FRAC. The ARP, however, with its emphasis on the control and supervision of the external assessment process, would arguably be more effective in supporting the external assessors and also in safeguarding the integrity of the assessment process.

**Internal audit and board of management**

The comparison of fieldwork findings and the ICAS (1993) proposals identified one similarity and one difference.

**Similarity**

- In the model followed by the interviewee companies, the relationship between the two bodies was similar to that proposed by ICAS (1993), in so far as internal auditors provided assurance to the board on the effectiveness of management control and information systems.
Difference

- ICAS (1993) proposed that internal audit would also report to the FRAC and that the FRAC would be actively involved in preserving internal audit independence and effectiveness. In the event of any difficulty arising, the ARP would also take an interest in the situation. This provides stronger support for internal audit than appeared to be the case in the Dutch companies, with the supervisory board, largely through the audit committee, playing a more limited role in this area.

Supervisory board and board of management

The comparison of fieldwork findings and the ICAS (1993) proposals identified no similarities but two differences.

Differences

- The ARP has no direct responsibility towards the board of management, since it would exist primarily to oversee the external assessment function. The Dutch supervisory board, by contrast, has a statutory duty to supervise the management board.

- The ARP would have less contact with the ongoing operations of the business and would, as a result, appear to have more independence than the supervisory board. This could enhance the effectiveness of the ARP.
CHAPTER TEN

EFFECTIVENESS OF DUTCH INTERNAL AND EXTERNAL MONITORING BODIES

This chapter discusses the effectiveness of each of the monitoring bodies in turn, considering both the means by which the companies assess effectiveness and the interviewees' perceptions of the level of effectiveness achieved. Any actual or potential limitations on effectiveness are also identified and their implications explored. Comparison is made with the ICAS (1993) proposals.

While the perceptions of the parties concerned are of interest in their own right, it must be appreciated that no objective evaluation of effectiveness is conducted. Moreover, the effectiveness of particular monitoring bodies varies from company to company, being partly a function of the personalities involved in the bodies and the executive board. Nevertheless, certain general conclusions on the overall effectiveness of the corporate governance system do emerge. Inevitably, the similarities and differences identified here overlap with those identified in chapters eight and nine.

Audit committee/supervisory board

Questions were raised in the literature regarding the effectiveness of the supervisory board in the Netherlands. In particular, doubts were expressed about the ability of the board to function independently given its alleged remoteness from the company and its dependence for information on the management whom it was supposed to be supervising. The interviews, therefore, explored these issues.
Means of assessing effectiveness

This section considers the mechanisms in place to enhance effectiveness, the various assessors, and the critical role of co-operation between the supervisory board and the board of management.

Mechanisms

Mechanisms existed within the interviewee companies to enable audit committees to be effective: the holding of regular meetings to consider the periodic financial statements; and the regular reporting to the full supervisory board were all believed to contribute to the effectiveness of the committee. Audit committee effectiveness was assessed largely by the supervisory board, but also by internal and external auditors, based on the questions asked and the depth of understanding demonstrated.

Mechanisms had also been put in place to enhance supervisory board effectiveness; care was taken to ensure a high calibre and balanced membership of the board; regular meetings were held with formal agendas; supervisory board chairmen and executives confirmed that they were alert to the need to give adequate notice to supervisory boards of any important matters pending; and there were annual (albeit informal) evaluations made of supervisory board effectiveness. One supervisory board chairman summed up:

Self assessment of supervisory board effectiveness is not a structured point on the agenda. We do a self assessment but I'm not a believer in having a meeting of the whole board to sort out how we are doing. Of course we discuss this with the chairman of the board, the vice-chairman of the supervisory board and myself at least annually when we look at people leaving and so on. (Company B SB)
Assessors

The primary assessors of supervisory board effectiveness were executive management and, to a lesser extent, external analysts and shareholders. Company B's supervisory board chairman continued:

... we are assessed by the board of management. If it has doubts it will draw these to my attention. Also, the outside world is increasingly paying attention to the functioning of the supervisory board. Does it really know what is going on? Can it judge whether the internal organisation is efficient? Is attention being paid to important matters? Also the shareholders will bring it up at the shareholders' meetings. (Company B SB)

Executive directors confirmed that they believed they could assess supervisory board effectiveness. Executive directors could assess the strength of the supervisory board from the questions asked, advice given and the depth of supervision:

... with the very good supervisory board that we have, we have ample opportunity to ask for its advice on all sorts of subjects. There are always one or two members who know what it is all about in a specific country or business and I take their advice and ask for it. Then they call you at the right moment and can become critical - 'what went wrong here?' I suppose that is more supervision than advice! (Company B CE)

As one chief executive remarked:

The effectiveness is basically to have another input for the executive board and sometimes it is a rather different approach to challenges that we face. (Company C CE)

In addition to management evaluation of effectiveness, shareholders were also given the opportunity to evaluate the supervisory board at the annual general meeting (AGM):
There is another contact, at the AGM, where the supervisory board is also present and it could be that a shareholder or group of shareholders ask the board specific questions. A concern might be expressed by shareholders that they don’t feel the supervisory board is functioning properly, or if they have some doubts, they speak up. (Company B CE)

The critical role of co-operation

It does, however, seem a matter of concern that the principal judges of supervisory board effectiveness were the executives, who were the group being supervised. It is important to stress that there are cultural issues here. Both executive board and supervisory board members emphasised the co-operative nature of their relationship. One supervisory board chairman explained:

One can feel whether things are going well and whether there is full co-operation with the executive board. It is really the core responsibility of all members of the board . . . . Sometimes it is easy and sometimes it is a little bit more difficult, but if there are tensions or differences of opinion on important issues one can sense and feel that there is not good co-operation. That’s a point which I feel is important for a supervisory board to watch closely. (Company C SB)

If that co-operation were lacking, the supervisory board’s approach to its work would be very different. In fact, in extreme cases the supervisory task could prove so difficult that it could exercise its rights to remove executive directors and appoint others. It was emphasised that this was a ‘last resort’ situation, and if the need for this arose it would be a very bleak day for the company as it would indicate a total breakdown of the normal consensus approach to business life.

Level of effectiveness achieved

Audit committees were generally regarded as effective in analysing the financial information and especially in monitoring controls on behalf of the whole supervisory board.
Certain reservations were, however, expressed on whether all audit committee members understand in detail everything discussed, especially with rotation of committee membership:

*There are two members rotating on a three-year schedule and the quality of the audit committee meeting depends very much on the members and their backgrounds.* (Company C FD)

This raises issues of audit committee competence and one finance director, describing the package of detailed information supplied to the committee, said:

*The audit committee certainly has a function within the supervisory board where the discussion is about results and projections. The supervisory board rely on the audit committee report. There are extensive minutes on the audit committee meetings. The supervisory board has the booklet of information, it has the minutes and it has the chance to discuss these … . If you ask me, I don’t think all the audit committee members understand in great detail everything that is said here but at least there is a discussion about it.* (Company C FD)

There was a view that the requirement to discuss the detailed financial information with the audit committee had the beneficial effect of improving the quality of the documentation produced, and even that the fact of the existence of the audit committee was more important than the work they did. This raised doubts about audit committee effectiveness, which had a corresponding impact on supervisory board effectiveness, at least in the area of audit and financial reporting.

The existence, however, of the audit committee as a sub-committee of the supervisory board (in the two companies where this applied) was believed to be more effective than the previous situation when the whole supervisory board discussed the figures and control reports. This had been far too cumbersome. The current arrangements whereby these issues were studied and discussed in a smaller group had improved the focus of the supervisory board on these matters and also improved the quality of the analysis produced by financial management.
In discussions with executives and supervisory board members, the general view was that supervisory boards were effective (certainly in the companies interviewed). The factors cited as contributing to this effectiveness were the quality of the individual members in terms of experience and dedication, the openness and quality of information supplied by management, and the liaison between supervisory boards and other monitoring bodies. One supervisory board chairman stated:

*I feel that the supervisory board makes it absolutely clear for the managing board that it has to inform and justify its decisions in a more detailed way than in an annual report or in a shareholders' meeting. It has to do this on a regular basis, to people who are more interested in the business than an average outsider, who after years of serving in such a supervisory board become experienced and know a little bit about what is going on. And I don't see how you can find a better way of doing that. (Company C SB)*

All executive directors interviewed regarded their supervisory board members as high quality individuals with a great deal of experience. The effectiveness of the co-option system is currently being debated in the Netherlands, but the executive and supervisory board members interviewed believed that this system, coupled with liaison with the executive board on potential new members, was regarded as the best way of ensuring that quality was maintained. The high ability of supervisory board members meant that executives had to argue their position on any particular issue with these individuals, and to justify their proposals, this was a good discipline and also helped the supervisory board to keep a 'tight grip' on executives. The expertise of board members was believed to be matched by their sharpness and application to their task. For example:

*They are effective. Their main functions are supervision and advice. They supervise every meeting. It's difficult to say whether that is completely satisfactory, but I think so. The same thing in the case of advice. They do give advice, asked for or unasked for, so I am confident the supervisory board functions. (Company B CE)*
Constraints

Reservations were expressed on the effectiveness of supervisory boards. Company A’s finance director, while maintaining that the supervisory board was effective, admitted that this effectiveness – indeed the effectiveness of the whole organisation – depended on honesty and openness in relationships, particularly in the supply of information from management. There was, therefore, a risk that biased information was fed to supervisory boards. His chief internal auditor commented that the problem was not withholding information but of putting a particular slant on it:

... there are always topics in every company which are not black and white, but grey. It is important to give proper information ... then the supervisory board can draw its own conclusions. Now it often happens that ... it gets the information with the conclusions. Then it is very difficult to make up your own mind. I have the impression that our board of management is rather strongly present at the meetings of the supervisory board and that is the reason the supervisory board can’t make up its own mind. (Company A CIA)

The time available was also considered to be a problem:

It is supposed to overview the activities of the group ... but it bases its judgments on the information given by the board of management and the supervisory board does not spend too much time on it. The board members read the minutes in the car - that’s common practice, isn’t it? Cars with chauffeurs! To raise good questions, to do a good job is very difficult. (Company A CIA)

One chief executive thought that supervisory board effectiveness as a control body was fairly limited. It, therefore, acted more as a sounding board than a monitoring body. A supervisory board, notwithstanding the quality of its members, could not undertake its work effectively because of the twin problems of insufficient time and information:
The law demands more than it can deliver and certainly I think the direction that we are going in corporate governance overestimates the impact the supervisory board can have .... If you really want to understand a company like ours or even more complex organisations it is almost a full-time job. (Company C CE)

Interviewees expressing reservations stressed that these were based on their observations as outsiders and, with one exception, directors and supervisory board members were positive about effectiveness, at least in their own companies. Nevertheless, these deficiencies, if real, have serious implications for the whole corporate governance structure. Supervisory board members, while recognising the risk that they could be led in their thinking, did not believe that this was happening. They considered that they could assess the relevant issues in sufficient detail in the time available, especially since much of the detailed discussion on financial matters took place in audit committee meetings reporting to the full supervisory board. Also, if they were not being given enough information, internal or external auditors would advise them of this.

I think being led in our thinking is a danger we will always have. Even management runs that risk in its own organisation but I think, certainly in this industry, I would consider the risk smaller than in some other industries. I think internal audit is there to give that sense of comfort to the supervisory board. (Company B SB)

The role of shareholders

The supervisory board chairman of company C summed up the situation by saying that it was assessed by management, shareholders and external analysts. However, doubt must be cast over the effectiveness of this assessment. Several interviewees admitted that in Holland, in common with other countries, there was an unwillingness among shareholders to become involved in the running of their companies. Consequently, it was unlikely that much reliance could be placed on them to improve supervisory board effectiveness. The Peters Report (1997) suggested that the influence of investors should be extended. In the present
circumstances, a supervisory board could, on the face of it, appear effective, but in fact do little more than rubber stamp the executives' decisions. The lack of independence would only become apparent when some disaster overtook the company.

The role of external auditors

The executive directors could arguably have an interest in maintaining a weak supervisory board in order to pursue their own agendas, and since these individuals would probably ensure that internal audit was also weakened, internal audit would be unlikely to have the power to oppose them. The only other party who could conceivably bring such a situation to light would be the external auditors. One chief executive commented on the role of external auditors in circumstances where executives concealed information from the supervisory board:

In that case the external auditor would have a role to play. But in most instances it would be very hesitant to do that because of the powers of the executive board over the external auditor. (Company C CE)

Comment

Audit committees were generally regarded as effective, although doubt was expressed as to whether all committee members fully understood the data supplied to them. On the whole, the existence of audit committees was regarded as positive, if only to force accounting staff and auditors to be more thorough in their preparation of the periodic information produced.

The effectiveness of audit committees and supervisory boards was assessed mainly by management. The extent to which recommendations were heeded and advice was sought gave a good indication of how they were perceived. To a lesser extent, supervisory boards also came under the scrutiny of shareholders and analysts, who had opportunities to respond to supervisory board reports and ask questions at the AGM. The fact that the principal assessors of supervisory board effectiveness were the
executives, who were the group being supervised, did indicate a potential weakness in the structure. It was stressed, however, that in the Dutch business culture the relationship between the two was one of co-operation rather than confrontation.

There were mixed views on whether supervisory boards were, in fact, effective. Generally, executive directors and supervisory board members were more positive about supervisory board effectiveness than internal auditors. Concern was expressed that supervisory board members could be 'led' in their thinking by management. Management, attending supervisory board meetings, could forcefully present information with conclusions already drawn, making independent assessment more difficult. In addition, some individuals thought that the shortage of time lessened supervisory board effectiveness.

The power of executives to limit supervisory board and audit committee effectiveness was a potential problem and it appeared doubtful that an executive board determined to pursue its own agenda in the face of the interests of the company would be prevented from doing so.

**Comparison with ICAS (1993) proposals**

Interestingly, one supervisory board chairman described his board members as:

> ... semi-insiders, interested people who will be there next year as well ...

(Company C SB)

Such a description might be applied to ICAS (1993)'s ARP, a body having responsibility for supervising the external assessment process rather than supervising the executive management, on behalf of the primary stakeholders. The ARP would, however, have greater independence than the supervisory board, being more remote from the directors. This would be a mixed blessing, however, because its greater independence would be countered by its lack of knowledge of current developments within the company. Arguably, ICAS (1993)'s proposals would create a body with even less understanding of the day-to-day operations of the company than the supervisory board.
The ARP's main role, however, would be the supervision of the assessment process, rather than the supervision of directors, and it would rely on external assessors more than management for information. Its greater remoteness from the day-to-day running of the business could be an advantage because its members would be less likely to have their thought processes conditioned by the arguments of the executives. A suitably motivated ARP could strengthen the hand of external audit.

**Internal audit**

Independence of internal audit is fundamental to the effective operation of the ICAS (1993) proposals and the literature review indicated an independence and status for internal audit that was greater than one might expect for an internal body. Interview discussions were, therefore, directed towards appraising whether internal audit in the companies visited was free from interference in the way it planned and executed its work, and also whether the status and authority of internal audit was such that its contribution was valued and recommendations heeded at all levels within the organisation.

**Means of assessing effectiveness**

This section considers the evaluation of internal audit by: the board of management and supervisory board; external auditors; and lower management.

**Evaluation by board of management and supervisory board**

Effectiveness of internal audit was assessed by both the management and the supervisory boards. The management board assessed it by the depth and insight of the comments in management letters and other reports. In addition, the extent to which problems throughout the group were identified and notified at an early stage to management by internal audit was a measure for effectiveness. The unexpected emergence of serious problems would cast doubt on the efficient functioning of internal
audit and prompt remedial action. Although it might be argued that this was in a sense 'closing the stable door after the horse had bolted', the directors interviewed affirmed that the track record of their internal audit functions in this area gave them confidence that the functions were operating effectively. For example:

*We consider what is in their management letters. Are they interesting? Do they pick up good points? Are they very different from what our external auditors are saying when the letters are combined? When we send our internal auditors to faraway places or to specific projects they write a report and we find that, if we are unhappy with it, it is because the information in the report is worrying rather than because the report is bad. So we judge quality in this way.* (Company A FD)

**Evaluation by external auditors**

Supervisory board members argued that they would know whether internal audit were performing its work effectively from the quality of internal audit reporting and the questions asked at audit committee meetings with both internal and external auditors. One supervisory board member commented that, although detailed monitoring of internal audit was the responsibility of management:

*... the chairman of the supervisory board and the audit committee, after discussing the management letter and the audit report ask the external auditor, 'Are you confident with your internal auditor here because you have to use him as the basis for your certificate and is there anything else you would like to report that is not written here?'* (Company B SB)

External auditors, therefore, also had a view on internal audit effectiveness, because of the close working relationship between the two. It was believed that they would be quick to advise management and/or the supervisory board if they were dissatisfied with the internal audit work. External audit assessment of internal audit effectiveness was more direct than that of the supervisory board, which appeared to rely largely on external audit to warn it of internal audit failings.
Supervisory and executive boards had informal independent assurance on internal audit effectiveness. If external auditors experienced problems with internal audit, they would notify one or both boards. This was particularly evident in company A where internal audit largely followed external audit methods:

*When we measure internal audit output we ask whether they (within the context of external auditors) function correctly. Do they certify the accounts and are the certificates accepted by external audit? We would then discuss the effectiveness and efficiency of the internal audit department with external audit. They warn us about specific points if they are concerned.* (Company A FD)

In company B also, this process of appraising internal audit through external audit was evident:

*I speak regularly to the external auditors .... Recently ... we briefly discussed their co-operation with internal audit and they confirmed it is going well.* (Company B CE)

**Evaluation by lower management**

In addition, top management were interested in the 'client' satisfaction of lower management. The extent to which internal audit tackled and solved problems throughout the group was a measure of its achievements. One chief executive observed:

*The main effectiveness of internal audit is at the lower end of the operating companies where the managers review the findings of internal audit. How do you measure effectiveness? I measure it to an extent by listening to the CEO's and CFO's of the various operating companies to tell me whether they find the whole exercise helpful and whether it actually contributes to the way they run the business. That to me is the main point.* (Company C CE)
His chief internal auditor agreed:

*You should look first to the kind, quality and number of recommendations that internal audit produce. That is the only product that it has, I think. That's the only way you can see its worth. Another factor is the degree to which the recommendations are followed up by the company. The degree to which it can convince operating companies to follow them up is, of course, a signal for better quality.* (Company C CIA)

Of course, if operating management had a negative view of internal audit, they might ignore recommendations that were, in fact, sound:

*That would not be an acceptable excuse for our board. I think the function is well accepted by the different companies. I don’t say internal auditors are the most liked people in the company, but I think the board know of our existence and that our function is to help them.* (Company C CIA)

The high profile of internal audit depended on the patronage of top management. If that were withdrawn or diluted, internal audit effectiveness would be affected.

**Level of effectiveness achieved**

The unanimous view of interviewees was that internal audit within all companies operated effectively, with executive directors and supervisory board members relying on the information supplied through internal audit. Although much of the assessment of internal audit effectiveness within the companies was output based, the quality of internal audit in all companies was enforced through the internal audit charters or equivalent. Its status within the organisation, reporting to the parent management board, the freedom to programme its work to its own perception of need, the comprehensive nature of its remit and the employment of high quality, trained staff all contributed to its effectiveness.
Qualifications and status

Internal audit teams in company A held the same qualifications as the external audit team, were sent on external auditor training courses and used the same documentation and procedures, with the intention of ensuring quality. In company B, the policy statement of internal audit stated:

*In principle, internal audit recruits university and higher vocational graduates. Ample training facilities are available for further development, including theoretical education …*

(Company B Internal Audit Policy Statement)

In the same company, the profile of an internal audit staff member included the following:

*For internal audit to work effectively, the technical expertise and, in particular, personality of its staff must be of the highest standard. Staff must be able to work effectively at various management levels in the company, think creatively, have strong communication skills.*

(Company B Internal Audit Policy Statement)

One chief executive thought it was important for the functioning of the system within his company that there was a high-profile internal audit function, with authority:

*I think it does have an impact on the effectiveness of internal control when people know that internal audit have to report to me.*

(Company B CE)

Interviewees argued that since audit performance was underpinned by such specifications, and given the high expectations of customers it was appropriate to assess effectiveness by monitoring customer satisfaction.

The chief internal auditors interviewed were all high-profile individuals whose functions carried a great deal of influence within the organisations concerned. In addition, the status of internal audit was much higher than is traditionally regarded as being the case in UK companies. A number of possible reasons were suggested for this:
It might be culture or it might be a few leading figures in the auditing world have supported the internal audit function a great deal. I think that is what happened in Holland. But also, when the external audit function restricts itself to largely approving a set of accounts then there is a need for that hole to be filled. Another reason is efficiency because once you talk about full-time jobs the external audit function is twice as expensive as internal audit. (Company C CE)

The early Philips model in Holland involved the creation of a high-profile internal audit function, which was to a large extent relied on by the external auditors. However, the last two reasons suggested would not be specific to the Netherlands.

There is, therefore, no prima facie reason why the establishment of a similar high-profile internal audit function could not become a more common feature in the UK.

**Independence**

The issue of independence and the perception of independence were regarded as important. In all companies, internal audit reported directly to the chairman of the management board. The relatively strong position of internal audit was illustrated in the Function Description of Group Audit in Company B:

*The internal audit function fulfils an independent function on behalf of the managing board and other executive levels within the organisation. The independent character of the function is expressed in internal audit being placed below and reporting to the group controller. The head of internal audit is also authorised to report direct to the chairman of the managing board and the chairman of the supervisory board. The group-wide character of the service means (group internal audit) has functional authority for internal control in the company as a whole ... and for the internal auditors at subsidiary companies and at the international branches. (Company B CIA)*
Executives and internal auditors interviewed agreed that the support of the parent board helped internal audit to take a stance of greater independence in relation to the operating companies. One internal auditor cited examples of situations where the parent board had sided with him when subsidiary management had complained about a particular matter that he had refused to sign a certificate on the grounds that the contents could not be verified:

_The subsidiary’s management were very upset. They said ‘we are losing money because you won’t certify’ and they went to the parent management board, but it said ‘No, the auditor’s right.’ I never have problems in this respect._ (Company A CIA)

Although internal audit did appear to have autonomy up to parent board level, it could be subject to control at that point, because it operated as a tool of management. The view across all the companies, however, was that the executive board did not interfere or limit internal audit independence, even if it disagreed with the points being made by internal audit:

_We are 100% independent. To be honest, I would say that our supervisory board and board of management treat us with respect and they give us all the possibilities to report to them what we want to._ (Company A CIA)

In the face of an executive board determined to limit the scope of internal audit work, the ability to approach the supervisory board or, perhaps more likely, external audit should, in theory, protect its independence. However, in practice, independence may not be so easy to maintain. It was apparent that internal auditors would only approach supervisory boards as a last resort, and, even further down the line, at subsidiary level, total independence may be an illusion. One finance director remarked:

_What is ‘independent’? You cannot report to the very top without discussing what you are going to report and what you are going to report is influenced by the discussions you have. I mean, we are all human beings. So, independent, yes, in the way of organisational charters,
but I think internal audit is always somehow dependent. I didn’t mean that as a negative statement. Our external auditor is not independent from us either! (Company C FD)

Ultimately, effectiveness was not viewed as a function of systems:

In my experience it’s basically not a matter of organisation .... It’s a matter of personalities, acceptance of principles etc rather than anything else. Too much weight has often been given to the way in which it has been formally organised. Effectiveness largely has to do with people .... If there is a CEO (and I know them) who basically thinks that internal audit are a pain in the neck then it can do whatever it likes but its effectiveness will be largely diluted and in any system there are very few ways of going round that. (Company C CE)

Nevertheless, a system of corporate governance that included checks and balances was seen to provide a framework that limited the extent to which executives or others could wield destructive powers.

Comment

Internal audit effectiveness was assessed mainly by results: the extent to which problems were identified and solved, and by ‘client satisfaction’ at all levels of the organisation. Performance indicators did appear to exist for assessing internal audit effectiveness. These qualitative indicators all appeared to be output-based, relying on qualities of reports, problems identified and, from a negative perspective, the failure of unexpected problems to materialise. There was a risk that difficulties which the parent board management had not anticipated, especially at foreign subsidiary level, could go undetected.

In the companies, the parent management board, supervisory board, external auditor and subsidiary management all formed separate views of effectiveness. Internal audit was regarded as effective because of the independence and authority it was perceived to possess within the organisation, at least up to parent board level. Also, and perhaps more importantly, internal audit was regarded as effective because of the quality of the personnel involved.
It is, however, difficult to see how internal audit can be effective at a level above the chief internal auditor unless permitted to be so by the executive board. In the final analysis, an executive board determined to inhibit the work and influence of internal audit could do so. Its ability to maintain autonomy must lie not only in its own will and expertise, but in the effective functioning of the supervisory board and the external auditors.

The question also arises as to whether it is reasonable for internal audit to take responsibility for monitoring all business controls in large organisations. Even with an internal audit function of c150 members, as in company B, the volume and diversity of areas requiring to be addressed presented a formidable task.

Comparison with ICAS (1993) proposals

The ICAS (1993) proposals for a strong internal audit function parallel closely the Dutch system with similar close relations with external audit, quality assurance procedures and reporting responsibilities. Internal audit in the companies visited operated independently and with authority, in line with the ICAS (1993) proposals. In the Netherlands, however, the practice of internal audit is increasingly becoming focused on operational audit rather than the financial audit emphasis of the ICAS document. From the literature, it appears that this trend is paralleled in the UK. It is likely, therefore, that the ICAS (1993) proposals will require modification before their introduction would be feasible. This is addressed in chapter eleven.

The problem of control by the parent board was recognised by ICAS (1993), and its proposals place the FRAC in the role of protector of internal audit independence. Any deficiencies in systems identified by internal audit which are not resolved by executives should be reported by the chief internal auditor to the FRAC, with a copy being sent to the external assessors. The assumption that the FRAC would have the power to persuade executives to make changes in systems may presume an influence for non-executive directors which is not borne out in reality.
External audit

Although no external auditors were interviewed, it was considered appropriate to discuss the company officials' view of external auditor independence and effectiveness. This, of course, has been much debated in recent years, especially in the Anglo-Saxon literature. In particular, the closeness of external auditors to the executive directors, and their economic dependence on directors' goodwill has arguably impaired their ability to function effectively. Under the ICAS (1993) proposals and the Dutch model, external auditors work very closely with internal auditors, and the view has been expressed that internal auditors could act more independently than external auditors. Given the close co-operation, it was considered that it would be interesting to discuss whether internal and external audit in the companies visited were seen to enhance each other's independence and effectiveness.

Means of assessing effectiveness

The close working relationship with external auditors gave internal audit a greater insight into external audit effectiveness than was generally the case in the UK. Both executive board and supervisory board members confirmed that they looked to internal audit to advise them if the external auditors were not functioning effectively. Since internal audit derived support from the external audit, it would also have an incentive to complain if any problems arose in the relationship. Management also assessed external audit effectiveness via the discussions at all levels with external auditors and via the contents of the management letters. One chief internal auditor explained:

*I am not the only one who assesses external audit effectiveness. The finance director does it because he is very much involved with them in the consolidation process. Management of the operating companies are confronted with external auditors as well. (Company C CIA)*
Supervisory boards were also interested in external and internal audit effectiveness and gained satisfaction on this through questions and discussions with both sets of auditors during audit committee meetings.

Level of effectiveness achieved

Discussions on whether external auditors were, in fact, effective focused primarily on two quality components: auditor independence; and technical competence.

Auditor independence

Notwithstanding the power of the executive board, interviewees in the companies believed that their own external auditors were independent from the directors and expressed little patience with auditors who compromised their independence:

_There is a bit of a dilemma for the profession when auditors are sleeping under the same blanket as their clients and the level of the profession is so low that they should be ashamed of it. My feeling is that we don’t have to talk about this issue in Holland._ (Company A CIA)

His finance director agreed:

_I think we should not always have to share the same views as our auditors. If they put something on the table that we do not agree with we will argue about it. It is important that we see each other’s viewpoint. I would think that if we felt that they were following our line of thinking we would probably feel very uncomfortable._ (Company A FD)

Nevertheless, there was recognition that the audit profession has changed, in the Netherlands as elsewhere, that there was more price competition, that supply exceeded demand and, therefore, that there was more pressure to keep the customer (ie the executive directors) happy. The view was expressed that internal auditors were in some respects more independent than external auditors. An internal auditor with the
full backing of the parent board could be more independent in dealing with subsidiary companies than the external auditor who had to avoid offending management at all levels in the organisation.

It was argued that independence is a state of mind and that only the profession could strengthen auditor independence:

*Being chartered accountants, by nature you are independent. The public must look at you when you make your declaration as being independent, so in that respect I would say that if that is an issue, it is so because of a lack of professionalism in the external audit function. Personally I think independence is not a problem.* (Company C FD)

Effective internal auditors and, in exceptional cases, supervisory boards also had a role to play in the monitoring of the independence of external auditors.

**Technical competence**

In relation to technical competence regarding the financial statements, the general view was that, although external auditors were skilled individuals, they were sometimes in a difficult position as they did not have enough information available to challenge management assertions. One chief executive suggested that management reported whatever profits it wanted. If external auditors queried the figures, justifications could easily be produced for making or not making adjustments, as appropriate. This rather cynical view of auditor effectiveness was not widely held, although one internal auditor related an incident where he had recently criticised his external auditor for agreeing a bad debts provision with local management that was inadequate. In the eyes of the internal auditor, the external auditor had been too easily persuaded. The general view, however, was that external auditors could collect sufficient reliable evidence in support of the figures and were competent to do their work.

External auditors were also thought to be competent in the consideration of control effectiveness, although doubt was expressed that this situation would continue, given the blurring of the dividing lines between financial and operational controls. External audit would be
driven towards greater reliance on internal auditors. This would give
greater impetus to the ICAS (1993) proposals for the external auditor to
take the role of assessor. A further trend is the change in audit approach
by the international accountancy firms. In essence, these developments
mean that 'audit' in the sense of a periodic detached assessment of processes
and systems, is replaced by continuous involvement by auditors in the
operation of the business throughout the year, and constitute a further
blurring of the distinction between the work of internal and external
auditors.

In addition, the increasing demand for reliable real-time information
on company performance and position on the Internet and through other
media creates a corresponding demand for real-time auditing. This is
likely to force the external auditor into an increasingly close working
relationship with the client's audit committee and internal audit. A logical
extension to this process would be the outsourcing of internal audit to
the external auditor, and this is taking place in a number of cases.

Comment

The effectiveness of external auditors was assessed by internal audit,
by management and also by supervisory boards through the audit
committee. It was, however, internal audit who had the greatest insight
and arguably the greatest incentive to complain if external auditors were
perceived as ineffective in some measure. The general view among
interviewees was that external auditors, at least in the companies visited,
were effective both in their independence and competence and that this
was the way the directors wanted it to be. As the chief executive of
company B commented:

_I must say that the man in charge of our audit knows what he is talking
about with respect to the organisation. That is very welcome to me._
(Company B CE)
Interestingly, from the perspective of the ICAS (1993) proposals, there was a view that, without reliance on internal audit, external audit (at least within the companies visited) would find it increasingly difficult to achieve their objectives in the future.

Comparison with ICAS (1993) proposals

The twin problems of external auditor independence and competence were both addressed by the ICAS (1993) proposals for close liaison with internal auditors. The increasing integration of control systems suggests that external auditors could become increasingly reliant on internal audit for assurance on control effectiveness. However, as the shift in external audit approach takes hold, external auditors will in future focus on controls instead of financial statements. The audit will become more process-oriented than data-oriented. As a result, external auditors are likely to work in multi-disciplinary teams and specialise in particular industries. They will become general assurance providers, while internal auditors will support control self-assessment systems and facilitate the effectiveness of external auditor activities.

Dutch internal auditors interviewed considered that the independence of both sets of auditors was strengthened by their relationship and that internal audit sharpened the focus of the external auditor. While this was obviously not an impartial view, there was no doubt that the close relationship improved the overall audit effort. This would suggest that the ICAS (1993) proposals could represent a way forward in a UK context, although there were mixed views as to whether the external auditor's role could be limited to that of an 'assessor' because of public expectation and statutory duty.

Summary

The similarities and differences between the perceived effectiveness of Dutch monitoring bodies and the anticipated effectiveness of those proposed by ICAS (1993) are summarised here.
Audit committee/supervisory board

In comparing the fieldwork findings and the ICAS (1993) proposals one similarity and three differences were identified in relation to the audit committee and supervisory board.

Similarity

- Both the supervisory board and the ARP could be classed as 'semi-insiders'.

Differences

- The primary responsibility of the supervisory board is overseeing management which is different from that of the ARP which is overseeing the external assessment process.
- The proposed ARP has greater independence than the supervisory board being more remote from the directors.
- Greater independence could result in the ARP having less knowledge of current developments and day-to-day operations of the company.

Internal audit

Two similarities and two differences in relation to internal audit were identified by comparing the findings of the fieldwork to the ICAS (1993) proposals.

Similarities

- The ICAS (1993) proposals for a strong internal audit function parallel closely the Dutch system with similar close relations to external audit.
- Dutch internal audit is free to communicate with external audit which is in line with the ICAS proposals.
Differences

- The ICAS (1993) proposals emphasise financial audit whereas internal audit in the Netherlands is focused increasingly on operational audit.
- ICAS (1993) proposes that internal audit report to the chairman of the FRAC, as well as to the chief executive (as in the Dutch system), giving greater internal auditor independence.

External audit

One similarity in relation to external audit was identified by comparing the fieldwork findings with the ICAS (1993) proposals.

Similarity

- The ICAS (1993) proposals for placing greater reliance on internal audit are in line with the Dutch system.
CHAPTER ELEVEN

SUMMARY AND PROPOSALS

This chapter begins by providing a brief summary of the main findings presented in chapters eight to ten regarding the different monitoring bodies within the companies visited. The impact on the audit function is emphasised. Conclusions are drawn from the Dutch experience that have implications for the UK. These are presented as strengths and weaknesses. Thereafter, developments in the fields of financial reporting, auditing and corporate governance are presented and the implications discussed. This confirms the desirability and feasibility of many of the ICAS (1993) proposals, while enabling suggestions to be made for changes to the original ICAS (1993) proposals to take into account developments since 1993 and expected future changes. This approach to developing modified ICAS proposals is illustrated in Figure 11.1.
Summary of Dutch findings

This section presents the main findings and conclusions first for the audit committee/supervisory board and then for internal audit. Cultural issues are also addressed.
Audit committee/supervisory board

In this sub-section, the main findings in relation to the audit committee/supervisory board are presented.

Functions and responsibilities

The main functions of the supervisory board were to supervise management on behalf of all major stakeholders and to act as a sounding board for management ideas. Supervisory board members interviewed saw this as an active process rather than purely a response to management initiatives. Supervisory boards also had the power to appoint and remove executives, and to approve financial statements and major investments. Through the audit committee, the supervisory board attempted to obtain assurance on the effectiveness of control systems and financial reporting through liaison with internal and external auditors.

Interfaces

In attempting to fulfil their responsibilities, supervisory boards worked closely with the parent management boards, through both formal and informal meetings, to ensure that the supervisory boards were advised of developments within the organisation and to enable supervision of management to take place. At a lower level, supervisory board members also met periodically with management of subsidiary companies to obtain detailed information on local situations. The audit committees also met periodically with internal and external auditors to consider their reports.

Effectiveness

There were mixed views on the effectiveness of supervisory boards. Generally, board members and executive directors tended to take a bullish view of their effectiveness, whereas internal auditors were less enthusiastic, believing that there was a possibility that supervisory boards tended to be strongly influenced by the executives they were supposed to supervise.
Lessons to be learned from the Dutch experience: strength and weaknesses

Although the creation of a two-tier board structure formed no part of ICAS (1993)'s proposals, the existence of a group of independent specialists within the company could constitute a strong element within a future UK corporate governance structure. Such a group could arguably operate more autonomously than non-executive directors in the present structure.

**Strength: Existence of a group of independent specialists within the company**

The existence of the supervisory board offered the possibility of the creation of a group of independent experts within the company who had an interest in preserving the independence and effectiveness of both the external and internal auditors. In the Dutch model, this was not the primary function of the supervisory board but, although reservations were expressed on supervisory board effectiveness in this area, the parallels with ICAS (1993)'s ARP and FRAC gave an indication of how these bodies might function if the ICAS (1993) proposals were introduced.

Like the supervisory board, the ARP would report to shareholders in the company's annual report and act in the interests of a wide range of stakeholders, providing the vehicle for a widening of the accountability of companies. The ARP would also provide the opportunity for independent input to the external auditor selection process to a greater extent than that offered currently by the Dutch supervisory board.

**Weakness: Commonality of personnel on supervisory board and audit committee**

The audit committee was a sub-committee of the supervisory board in companies B and C, and the full supervisory board in company A. The ICAS (1993) proposals were to split the functions of these bodies, with the FRAC, comprising non-executive directors supervising the internal
audit process and the ARP, comprising independent specialists supervising the external assessment process. The FRAC, like the Dutch audit committee would rely on information from internal audit on control effectiveness and the quality of management information, and would therefore have an interest in ensuring that the company operated a strong, independent internal audit function. However, the audit committee's oversight of the internal auditors was a by-product of its main function of aiding the work of the supervisory board. The FRAC, however, would have a primary responsibility for the supervision of internal audit, with the added support of the ARP. This should constitute effective support and the reluctance of at least one Dutch internal auditor to approach the audit committee in the event of a problem should not arise under the ICAS (1993) model.

**Weakness: Lack of independence of supervisory board from management board**

The view was expressed, both in interviews and in the literature review, that supervisory boards were unduly influenced by parent management boards. This was mainly because of the lack of involvement in the day-to-day running of the company, the lack of time available and, most significantly, the fact that information was presented with conclusions already drawn. This approach made it more difficult for supervisory boards to think independently, casting doubt over the whole supervisory process. One chief executive observed that the law demanded more of the supervisory board than it could deliver, and that the board's impact was overestimated.

The ARP would arguably be more effective in supervising the external audit function and supporting the external auditors than the supervisory board because of its greater remoteness from the executive directors and because, unlike the supervisory board, this was its *raison d'être.*
Weakness: Lack of expertise of audit committee members

In two of the companies interviewed, audit committees operated as sub-committees of the supervisory board, and membership of the committees, with the exception of the chairman and vice chairman, was subject to rotation. This could mean that there could be a lack of financial reporting and auditing expertise on the audit committee. It was readily admitted that not all audit committee members understood everything that was going on. This could limit the committee's effectiveness in the supervision of the audit process.

Internal audit

In this sub-section, the main findings in relation to internal audit are presented.

Functions and responsibilities

Internal audit in the companies visited existed as a vehicle for management control, acting in a high-profile role with particular responsibility for giving assurance to management that the management information and control systems were operating efficiently and effectively. In two companies, the internal audit remit was very wide, with a mainly operational audit approach, investigating the full range of controls within the organisation - operational and compliance, as well as financial. Internal audit in these companies also assessed management effectiveness at subsidiary company level. In addition, internal audit was involved in risk management, ensuring that identified risks particular to the companies' industries were addressed appropriately. In the third company, the emphasis was primarily on financial auditing, but, even here, there was a suggestion that the future trend would be towards operational audit and, since the interviews took place, this company has outsourced its internal audit function to its external auditors.
Interfaces

Internal audit co-operated extensively with external audit in all companies to ensure that the overall audit effort was comprehensive and cost effective. This co-operation also strengthened the position and encouraged the efficiency of both auditors. Internal audit also liaised closely with the parent management board, being briefed by management on developments, and reporting to it the results of audit work. Internal audit liaison with the supervisory board was mainly through the audit committee, but the number of meetings was surprisingly small, amounting to one, two and four meetings per annum for companies A, B and C, respectively. Internal audit reported to the supervisory board through the audit committee and the supervisory board attempted to satisfy itself on the effectiveness of the controls and financial reporting, on the basis of these meetings. There were no facilities in the normal course of events for meetings directly between the supervisory board and internal audit, and doubt was expressed as to whether such meetings would be appropriate except in unusual circumstances.

Effectiveness

The effectiveness of internal audit was judged primarily by management, on the basis of the quality of reports and problems identified. It was also judged by external auditors, based on their experiences in working with internal auditors; and by the supervisory board, through the audit committee. In all cases, internal audit was regarded as an effective operation, functioning autonomously below parent board level and indispensable to management for the fulfillment of its control responsibilities. Although in the companies internal auditors and directors alike were adamant that internal audit had complete programming, investigative and reporting independence, it was apparent that this freedom was a function of the personalities involved, their capabilities and motivation and the culture within the company. A parent board determined to limit the effectiveness of internal audit would have little difficulty in reducing the impact of its work. In this event, internal audit
would be forced to turn to the supervisory board, either directly or through the audit committee, or, more likely, to the external auditors. This obviously pre-supposes a chief internal auditor who has the capability and motivation to improve internal audit effectiveness, which may not be the case.

Lessons to be learned from the Dutch experience: strengths and weaknesses

In this sub-section, a number of strengths and weaknesses of Dutch internal audit are identified.

**Strength: Existence of a strong internal audit function**

Internal audit within the companies was strong in terms of its size and the professional quality of its staff. It also operated independently within the organisation and enjoyed considerable authority and reputation. Internal audit was able to offer considerable assurance to executive directors and the supervisory board on the effective functioning of controls and the identification of problems at all levels of the organisation. Chief internal auditors also recognised that they were colleagues of management at subsidiary level and therefore their approach was to offer support and help rather than to confront. Heavy reliance on internal audit by the parent management board in the companies was apparent. One finance director stated that internal audit was ‘the essential tool for control in our organisation’.

The internal audit environment in the companies is, therefore, similar to that envisaged by the ICAS (1993) proposals to create a strong internal audit function, providing assurance to the management board and audit committee (FRAC) on the reliability of management information and control systems.
**Strength: Extended nature of audit work performed by internal audit**

The extension of internal audit work to operational control matters and risk assessment is significant as it indicates the evolution of internal audit to the status of adviser to top management on all aspects of the business from its traditional financial statement assertion focus. The trend towards a comprehensive assessment of controls is likely to continue because, as systems become increasingly integrated, the dividing line between financial and operational controls will be difficult to draw. In addition, breakdowns in operational controls may have serious financial implications for the company and are, therefore, of interest to management.

ICAS (1993) proposed that internal audit should perform much of the financial audit work carried out presently by external auditors. The shift in emphasis in internal audit work towards operational audit and risk management suggests that the internal audit role suggested by ICAS (1993) will need to embrace both financial and operational audit.

**Strength: Close co-operation between internal and external audit**

The quality of internal audit was also recognised by external auditors, who co-operated extensively in the planning, execution and review of the audit effort. External auditors also relied heavily on internal audit for the execution of detailed audit work. In company A, for example, the external auditor carried out no fieldwork and even in companies B and C, where the primary emphasis was on operational audit, external auditors depended on their work, especially in the area of control testing. The delegation of detailed work to internal audit was a major aspect of the ICAS (1993) proposals, and the companies interviewed constituted examples of situations where such a division of work appeared to operate well. The close inter-relationships between internal and external auditors meant that they acted as a mutual support, with internal audit acting in concert with external auditors to improve their effectiveness and independence. Also, this close relationship meant that they could play a
monitoring role on each other's effectiveness since they were ideally placed to be aware of shortcomings in their 'partners' work and, because of their mutual dependence would be motivated to take action.

**Weakness: Lack of independence of internal audit from parent board**

Although it was argued that internal audit operated independently within the companies, this was because the parent management boards wished it to be so. One internal auditor observed 'I am independent because my management wants me to be independent'. A parent board determined to limit that independence could do so and the consequences of internal audit expressing serious reservations about the conduct of senior management board members remain to be seen.

**Weakness: Lack of positive approach to supporting and monitoring internal audit**

In theory, supervisory boards could offer protection to internal audit, either directly or through the audit committee, in a situation where their independence was threatened. It is doubtful, however, whether they could do this effectively because of their own proximity to the management board. Although supervisory boards had an interest in confirming that internal audit was effective and rigorous in its work, this was a secondary consideration, with the main emphasis being on supervision of management. One supervisory board member thought it was primarily management's responsibility to supervise internal audit. If so, the only body who could protect internal audit from self-seeking management would be the external auditors. Indeed, one internal auditor stated that he would be more likely to turn to the external auditor for support, than to the supervisory board. It is doubtful if an external body could have sufficient influence to support internal audit in a hostile situation within the company.

ICAS (1993) suggested that internal audit independence should be safeguarded by the FRAC, with support from the ARP where necessary. This could provide a stronger level of support for internal audit than
appeared to be the case in the Dutch companies, with the supervisory board playing a more limited role in this area, mainly through the audit committee.

Cultural issues

The Dutch approach to corporate governance differed from the UK model in a number of ways. Apart from the structural differences such as the existence of a two-tier board system, the most striking cultural feature to emerge during the interviews was that of 'openness' in the way companies operated.

This non-confrontational approach to business life was affirmed in all companies and was evidenced in a number of ways. Members of management were present at supervisory board and audit committee meetings and management, supervisory board members and internal auditors expressed unease at the suggestion that auditors would want to meet privately with the audit committee. Such a procedure (which, it was argued, would only arise in an extreme situation) would be regarded as damaging to working relationships. In addition, the audit committee was not believed to act as a buffer between external auditors and management, because there was no need for such a requirement. On more than one occasion, while admitting that life was not perfect, interviewees expressed the view that their companies were open, there were no secrets and the internal and external auditors were encouraged to speak their minds even if they knew management would disagree. While it is not suggested that the approaches of different cultures can be interchanged easily, the emphasis on openness is consistent with the Cadbury (1992) proposals for financial reporting and corporate governance.
Key changes in financial reporting, auditing and corporate governance from a UK perspective

This section identifies the key changes that have taken place in the UK since 1993 in the areas of financial reporting, auditing and corporate governance. It then considers the implications that these changes will have on these areas.

Changes in the UK since 1993

Many changes in financial reporting, auditing and corporate governance have taken place in the UK since ICAS (1993) was published, and those that have significant implications for auditing in the twenty-first century are mentioned here.

Financial reporting

*Business Reporting: The Inevitable Change?* (ICAS, 1999) reflects the pace and extent of change in this area. Increasing globalisation and the growth of electronic commerce mean that the financial status of a company can change extremely quickly, and there is an increasing demand for current data to be available. ICAS (1999, p12) noted the existence of a 'business reporting expectations gap' between the current financial reporting model, grounded in the entity concept, periodicity and strict recognition criteria, and the need for users to have access to information on the current financial status of a company, the business risks to which it is exposed, and the value of 'soft assets' such as intellectual property and brands. ICAS (1999, pp68–70) suggested the creation of an electronic library-type resource, made available to external users, who would be able to drill down into the basic information to obtain the level of detail that they require.

The speed of electronic communication has increased and the volume of up-to-date information in the public domain is extending exponentially. The increasing availability of current information has raised public expectation for accurate data on company performance to be immediately
accessible. Company managers increasingly see their businesses as a series of continuous processes, rather than in terms of periodic financial reporting.

**Auditing**

The international accountancy firms continue to make significant changes to their audit methodologies adopting risk-based, strategic systems approaches (e.g. Bell et al., 1997), that emphasise audit of processes rather than concentrating on the periodic financial statements. There is also a trend towards the outsourcing of internal audit to external auditors.

**Corporate governance**

The publication of a series of reports consolidated into the *Combined Code on Corporate Governance* (Committee on Corporate Governance, 1998) and *Internal Control: Guidance for Directors on the combined Code* (ICAEW, 1999) has resulted in significant change in this area.

**Implications of these changes**

The implications of these changes for the future of financial reporting, auditing and corporate governance are considered under the headings of:

- *Increase in demand for real-time information and resultant changes in external auditor responsibilities*
- *Developments within the international accountancy firms and resultant impact on independence*
- *Requirement for internal audit*
Increase in demand for real-time information and resultant changes in external auditor responsibilities

The existing requirement for auditors to comment on directors’ statements on internal control and the demand for real-time information would require external auditors to be able to give assurances on the effectiveness of the control systems that produce the information. As a result, there would be a shift from assurance of output to assurance of process (ICAS, 1999, pp79-80). Although attestation of outputs would be required from time-to-time, especially where judgment is exercised, external auditors would require assurance on a continuous basis that controls are operating. This is likely to produce a greater involvement by external auditors in the internal processes of the company, working closely with internal auditors and others to confirm that controls are being maintained to manage all business risks.

Developments within the international accountancy firms and resultant impact on independence

The increasing speed of developments and the demand for current information together with the tendency for management to see its business in terms of processes rather than in terms of periodic financial statements (Ashton, 1998), has resulted in a corresponding change in approach by external auditors. Auditors now approach the company from a risk-management perspective, adapting the audit approach to mirror the client management’s own view of the business processes. The change in audit approach focuses on the competence of management to identify and manage business risk. Auditor evaluation of a company’s transactions flows from a grounding in knowledge about their larger systems context (Bell et al, 1997). Auditors will tend to become increasingly specialised and multi-disciplinary, developing expertise in specific industries and, therefore, more able to target a wide range of inherent risks faced by their client companies. This, in turn, will facilitate a more comprehensive and effective assessment of control risk.
Under this approach, however, the audit will become the foundation for developing new customised assurance services, to meet the needs of customers (i.e., decision-makers within the company) (Elliott and Jacobson, 1997). Auditors as business advisers will be able to provide client directors with information to improve strategic decision making.

These developments in business reporting and within the accountancy profession will increase the extent of involvement of auditors in their clients' business processes for three main reasons. First, the move towards providing real-time information on a constant basis and the auditing of process as opposed to product will lead to real-time continuous auditing. There will be an increasing degree of synthesis of internal and external audit either by developing a close partnership between the two, or by outsourcing internal audit to the external auditor. This is likely to lead to continuous auditor involvement with the client. Second, the involvement by the auditor in business monitoring and measurement, and assessing directors' effectiveness in business risk management will require the auditor to work more closely with directors, to shadow their decision making and compare its effectiveness with industry norms and other benchmarks. Third, the desire to add value to the audit by providing assurance services on a wide value of strategic issues will encourage the auditor to supply advice to management which would formerly have been classed as consultancy work and performed by a separate department within the firm.

Concern has been expressed that these changes could compromise auditor independence by assimilating the external auditor into the company's business processes to the extent that the auditor's reputation as a business adviser becomes dangerously linked with the company's success. By approaching audit work from the perspective of building a picture of whether management is really in control (Ashton, 1998) and by eroding the auditing/consulting distinction (Jeppesen, 1998), the interests of investors could become subordinated to those of management.

The corporate governance structures in place must encourage rigour and integrity to be applied to audit work to prevent manipulation of the financial reporting process by management and a loss of confidence in the audit process, and therefore the quality of information supplied to the market.
Requirement for internal audit

The growing demand for directors to report meaningfully on internal control effectiveness will create an additional role for a strong internal audit function. For example, ICAEW (1999) sought to provide guidance to assist listed companies to implement the new requirements relating to internal control introduced by the Listing Rules to give effect to the Combined Code on Corporate Governance. Directors have a duty to report on their internal control assessment, explaining how they had reviewed the effectiveness of these controls. ICAEW (1999)'s approach was based on the adoption by a company's board of a risk-based approach establishing a sound system of internal control, and monitoring its effectiveness. The risks to be addressed were broad, covering all significant business, operational, financial, compliance and other risks. ICAEW (1999) suggested that the board might delegate this review of internal controls to the audit committee and other board committees as appropriate, with the audit committee not only considering financial controls but also providing a single focal point for some or all of the wider review of internal control.

ICAEW (1999) regarded an internal audit function as an important means of assisting the audit committee to do this work effectively. ICAEW (1999) saw the main role of internal audit as being to evaluate risk and monitor the effectiveness of internal control, to provide the board with much of the assurance it requires in this respect (paragraph 29). This role for internal audit would be similar to that observed in the Dutch interviewee companies, especially companies B and C and echoes the statement in ICAS (1993) that companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfil its responsibilities (ICAS, 1993, pp35-6). While it was not suggested that the introduction of an internal audit function should be compulsory, ICAEW (1999), referring to Provision D.2.2 of the Combined Code, proposed that the board or the audit committee should assess the need for such a function at least annually.
Development of modified proposals

The changes identified earlier, together with the insights gained from the literature review and the Dutch fieldwork, suggest that, although much of the content of the ICAS (1993) proposals is still pertinent to the UK corporate governance environment, a number of modifications to the proposals will be necessary to suit current environmental conditions. These are presented below in the form of six proposals. Four argue for the retention of the original ICAS proposals, while two suggest that the role of key internal monitoring bodies be extended. The modified corporate governance structures are represented in Figure 11.2.

Establishment of a strong internal audit department

A strength of the Dutch system is the existence of a strong internal audit function. In the Dutch companies, directors relied heavily on the internal audit function to give directors assurance on the effectiveness of financial, operational and compliance controls within the organisation.
Figure 11.2: Modified corporate governance structures

Key:

- = report
- - - = supervise
- - - - = liaise
- - - - - = watching brief

* = Appointed by shareholders
** = Appointed by ARP
*** = Appointed by FRAC
and on the quality of management information. The chief internal auditor in company B perceived his role as an executive consultant who was specialised in risk management. Both ICAS (1993) and ICAEW (1999) also proposed that internal auditors should fulfil this role.

Companies should, therefore, establish an internal audit function with the capability of giving these assurances to directors. The chief internal auditor should report directly to the chief executive, rather than the executive board. This will help to ensure the independence of the internal audit function within the organisation. The chief internal auditor should also report to the FRAC (see below) and be free to liaise at all times with the external auditor (assessor). In the Dutch companies, the lines of reporting followed this pattern with internal audit reporting to the audit committee and the audit committee, in turn, providing information to the full supervisory board.

Retained proposal 1: Each company should appoint a strong internal audit team that is capable of providing the FRAC with sufficient information to fulfil its responsibilities on behalf of the board.

Close contact between internal audit and the FRAC

One weakness of the Dutch system is the lack of independence of internal audit from the parent board. Another is the lack of a positive approach to supporting and monitoring internal audit. In the Netherlands, the audit committee's role tended to be reactive and supervisory board members regarded management as having the primary responsibility for supervising internal audit effectiveness. It appeared doubtful that the audit committee/supervisory board would be able to offer meaningful protection to the internal auditor in the event of a conflict between internal audit and the management board. This indicates the need for a body such as the FRAC.

The chief internal auditor should, therefore, report formally to the FRAC in addition to the chief executive, on his or her findings, and the FRAC should play a more prominent role in monitoring and protecting the internal audit function than that exercised by the audit committee in the Dutch companies. In addition to receiving internal audit reports, the
FRAC should also have responsibility for approving the appointment and dismissal of the chief internal auditor, and should be involved in the strategic planning of the internal audit function, and in approving its annual budget. In this way, the independence and authority of internal audit would be enhanced.

Retained proposal 2: The findings of each investigation by the internal audit function should be reported to the chief executive, the FRAC and the external assessor.

Nature of internal audit work to be performed

Developments in corporate governance indicate that the work to be performed by internal audit in the UK is likely to become increasingly broad. A strength of the Dutch system is the extended nature of audit work performed by internal audit. This is consistent with the observation that the internal audit function in companies B and C was involved primarily in considering operational, rather than financial, issues. As the boundaries between financial, operational and compliance risks and controls become less distinct, internal audit will increasingly be required to adopt a wide perspective, necessitating a multi-disciplinary internal audit function. This development is likely to be mirrored within external audit as the two audit functions become more integrated and the external audit becomes process-oriented rather than product-oriented due to the use of new audit methodologies. Companies should, therefore, extend the remit of internal audit to cover operational issues.

The remit of internal audit could also cover the assessment of management performance throughout the organisation. The Dutch literature suggested that internal audit in the Netherlands operated as 'partners in business' with management and acted as internal consultants to the company, examining overall performance, including those of management. In the companies interviewed (especially companies B and C), internal audit examined the performance of management throughout the group and reported thereon to the parent board. The chief internal auditor in company B summed up his function's mission in terms of partnership with senior management.
The broad range of internal audit work undertaken in the Netherlands can be summed up as follows:

- to act as risk management consultants to confirm to the parent board and the FRAC that all significant business risks are identified;
- to confirm to the parent board and the FRAC that financial, operational and compliance controls are effective in practice;
- to give assurance on the quality of data emerging from routine systems and to review the quality of management information, including forecasts and systems producing soft information;
- to review the effectiveness of management at all levels of the organisation; and
- to liaise with external assessors on the allocation of audit work.

Extended proposal 3: The recommendation in ICAS (1993) that the chief internal auditor should report on the establishment and effectiveness of management information and internal control systems and on the conformity of financial statements with the accounting records and legal and accounting standard requirements should be extended to cover the matters identified above.

Close co-operation between internal and external audit and reliance on internal audit

A strength of the Dutch system is the close co-operation between internal and external audit. This shows that internal audit, adequately resourced and protected, is able to perform much of the detailed work presently carried out by the external auditors. The Dutch interviewees believed that close co-operation between the two auditors resulted in a more cost-effective and company-specific audit effort and improved the authority and independence of both auditors. In the companies interviewed there was a close working relationship between the two auditors. In company A the external auditor carried out no fieldwork, relying on internal audit which used the same programmes and audited to the same standard as the external auditor. In company C the chief
internal auditor expressed the view that, since 95% of the data for the financial statements came from routine systems, these could be adequately checked by internal audit. This left the external auditors to tackle the grey areas where the exercise of judgment is required, eg provisions, cut off and disclosure issues. The extent to which financial statement data comes from routine systems varies from one company to another, but is likely to be substantial in most cases. Given the reliability of modern computer systems in a controlled environment, such an approach would be appropriate over a wide range of organisations. External auditors should, therefore, seek closer co-operation with, and greater reliance on, internal audit.

As the move towards strategic systems-based auditing takes place, external auditors will be perceived more as partners with management than independent experts operating at arms’ length and the demarcation line between internal and external audit will become defined less clearly. This process is already occurring in companies which outsource internal audit work to their external auditors. The directors and internal auditors in the Dutch interviewee companies believed that co-operation between the two auditors led to a more effective overall audit effort. If correct, the integration of internal and external audit work will produce a more effectively customised audit product, geared to the needs of specific users.

Retained proposal 4: The external auditors should be renamed the external assessors and that to a considerable extent the work of the external assessors would carry out their work by assessing the work of a company’s internal auditors.

Formation of an ARP

A strength of the Dutch system is the existence of a group of independent specialists within the company. A weakness is the lack of expertise of audit committee members. Reservations, however, were expressed by Dutch interviewees on the ability of supervisory boards effectively to challenge executive strategies, not because of moral weakness on the part of supervisory board members but because the information on these strategies was presented to them with conclusions already drawn.
This made independent appraisal and evaluation difficult. Similarly, auditors working closely with client executives could become 'locked into' the directors' thinking processes and find it difficult to challenge conclusions reached on the adequacy of inherent and control risk management measures. An appropriately qualified ARP with responsibility for the supervision of the external assessment process on behalf of the shareholders while having regard to the needs of other stakeholders should, therefore, be established to protect the integrity of the external assessment process.

In the Dutch companies the supervisory boards had an interest in securing an independent and effective external audit function, but this was very much a secondary concern, with the primary emphasis of the supervisory board being on the supervision of management. The ARP, however, would have primary responsibility for the external assessment process and, being more remote from the day-to-day activities of the company, would be more independent of the management board than the Dutch supervisory board.

External assessors would rely to a large extent on an effective internal audit function, so the ARP would have an interest in supporting the FRAC in its supervision of the internal audit process. This could provide strong support for both the internal auditor and the external assessor while at the same time contribute to the quality of the overall audit process.

The audit process has been described as a partnership between the audit committee, internal auditors and external auditors and no longer only the domain of the external auditor (Percy, 1998). The influence of audit committees and the responsibilities delegated to them are growing (Accountancy, 1997). Anecdotal evidence indicates that in some cases audit committees in the UK are performing the role of a quasi-supervisory board. An ARP, however, would have more independence from the executives than an FRAC composed of non-executive directors and would, therefore, be better placed to oversee the external assessors. The increasing assimilation of the external audit (assessment) process within the organisation makes the formation of an ARP, if anything, more pertinent than in 1993.
Retained proposal 5: An independent ARP should be established to take responsibility for the supervision of the assessment process on behalf of the primary stakeholders, while being responsive to the needs of the secondary and tertiary stakeholders.

Role of the ARP

A weakness of the Dutch system is the lack of independence of the supervisory board from the management board. Another is the lack of a positive approach to supporting and monitoring internal audit (also mentioned in connection with proposal 2). Companies should, therefore, have an independent body in place to actively appraise and support the audit function.

ICAS (1993) suggested that the ARP should take a largely reactive approach to the supervision of the external assessment process, receiving reports from the external assessors and considering requests from stakeholders for the external assessors to perform additional investigations. The potential threats to auditor independence posed by the new audit methodologies suggest the need for an ARP that will be proactive in ensuring the integrity of the external assessment function.

The possibility for the ARP to be involved actively with external assessors in the planning, execution and reporting of their work should be explored. This would help to ensure that the assessment process is executed with rigour, to protect the shareholders, and to cater for the needs of other stakeholders. The ARP should also adopt a watching brief over internal audit, to preserve its effectiveness and independence, while relying on the FRAC for more detailed supervision.

Extended proposal 6(a): The role of the ARP proposed by ICAS (1993) should be broadened to a more proactive supervision of the planning, execution, completion and reporting of audit work undertaken by the external assessors. This would help to ensure that due rigour is applied to the assessment process.
New proposal 6(b): The ARP should adopt a watching brief over the internal audit function, to confirm its effectiveness and independence within the organisation.

Summary of modifications to ICAS (1993) proposals

In this chapter, the insights gained from the Dutch fieldwork are assessed in the context of the current UK environment to drive out proposals for change in the UK corporate governance system. Specifically, it is proposed that the original ICAS (1993) proposals be adopted, subject to the following modifications:

- the role of internal audit be extended to cover business risks, all internal controls, the quality of management information and the effectiveness of management;
- the role of the ARP be broadened to a more proactive supervision of the external assessors; and
- the role of the ARP be broadened to include a watching brief over the internal audit function.

In stage two of this project, these ‘modified proposals’ will be discussed with officials from a small number of large public limited companies in the UK.
Appendix 1

Interview Agenda

Functions and responsibilities of internal audit departments

A number of functions and responsibilities have been identified as forming part of the remit of an internal audit department. Which functions and responsibilities form part of the remit of your internal audit department?

Interfaces between the internal audit department and other bodies

The interactions between the internal audit department and other bodies are considered to be critical to effective corporate governance within a company. Which other bodies does the internal audit department interact with, with what frequency and in relation to which topics?

Functions and responsibilities of other internal monitoring bodies

Audit committees

- A number of functions and responsibilities have been identified as forming part of the remit of the audit committee. Which functions and responsibilities form part of the remit of your audit committee?
- The interactions between the audit committee and other bodies are considered to be critical to effective corporate governance within a company. Which bodies does the audit committee interact with, with what frequency and in relation to which topics?
Supervisory board

- A number of functions and responsibilities have been identified as forming part of the remit of the supervisory board. Which functions and responsibilities form part of the remit of your supervisory board?
- The interactions between the supervisory board and other bodies are considered to be critical to effective corporate governance within a company. Which bodies does the supervisory board interact with, with what frequency and in relation to which topics?

Assessing effectiveness

(a) Which measures, if any, do you use to assess the effectiveness of:
   (i) the internal audit department;
   (ii) the audit committee;
   (iii) the supervisory board;
   (iv) the works council; and
   (v) the external auditors.

(b) Which measures, if any, does your department or body use to assess its own effectiveness?

(c) Which measures, if any, are used by other departments or bodies to assess your effectiveness?

Any other items

For example, future directions and lessons from the past.
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THE FUTURE OF CORPORATE GOVERNANCE:
Insights from The Netherlands

In view of the high profile of corporate governance issues in today’s business environment, and the extensive debate that Auditing into the Twenty-first Century (ICAS, 1993) has attracted since its publication, it was thought to be desirable to revisit its proposals in the context of the current business and regulatory climate. This publication represents the first stage of an investigation into the future of the external audit function and corporate governance more generally. The research is centred on the proposals contained in Auditing into the Twenty-first Century and, because of the close parallels with Dutch practice, was set up as a collaborative project between ICAS and NIvRA in the Netherlands.

The report provides a review of the relevant Anglo-American and Dutch literature on internal monitoring bodies and presents the views of thirteen key individuals in three major Dutch companies. Recommendations are made regarding how the proposals in Auditing into the Twenty-first Century might be either confirmed or amended in the light of insights obtained from the Dutch fieldwork and of developments since 1993 in the areas of financial reporting, auditing and corporate governance.

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