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How the tone from the top influences internal auditors

In a recent project, WU researcher Anne d'Arcy investigated how internal auditors' judgements change when they have to report to both the management and the supervisory board and when they are told to aim for different goals. The key finding: What is communicated to internal auditors before the auditing process has a great impact on how they evaluate processes.

Usually, the public and the media only become interested in corporate governance when it fails. In the wake of events like the Austrian Hypo Alpe Adria bank insolvency, the global financial crisis, and the VW diesel emissions scandal, people are quick to call for businesses to be subjected to more comprehensive internal audit controls. But are more rules and legal regulations really the answer? Does it make sense to have a "two masters" situation, where internal auditors report not only to the management but also to the supervisory board? That's not necessarily a good idea, says WU Professor Anne d'Arcy, head of the Institute for Corporate Governance. If new rules also open up new, unwanted ways of exerting influence on internal auditors, they may be counterproductive to the goal of making internal auditing more objective. Together with her team, Professor d'Arcy investigated how multiple reporting lines influence the judgements of internal auditors. "Internal auditors play an important role in a companies' internal monitoring and control systems," Anne d'Arcy explains. "Internal auditors support the management's control, directing, and decision-making functions by checking internal processes for effectiveness and efficiency. Objectivity is essential here."

The crucial role of communication

For her study, Professor d'Arcy looked at two publicly listed companies, one from Germany and one from Switzerland. Two experiments with over 70 participating auditors were carried out. The participants were assigned to two groups. They were asked to evaluate internal controls and eliminate controls they deemed unnecessary. The controls were chosen so as to be realistic in the context of the company the auditors worked for. In the first group, auditors were instructed by their supervisor to keep in mind that reducing costs was the management's key objective. The second group was reminded that ensuring effective controls was a priority for the supervisory board. The results showed that the internal auditors who had been briefed about the management's cost reduction goal ended up eliminating more of the controls that were presented to them for evaluation. It didn't matter whether they'd received the instructions verbally or by email. "This effect is particularly strong if the controls to be evaluated are complex and broad in scope. Based on the discussions we held after the experiment, it seemed that the auditors had unconsciously adapted their decision-making behavior," Anne d'Arcy points out.

More rules are not the answer

When it comes to internal controls and corporate governance, calls for independence and objectivity abound. Anne d'Arcy's experiments show, however, that objectivity cannot always be guaranteed when there are several conflicting goals at play. "Our results clearly illustrate that internal auditors' judgments are influenced strongly by the tone from the top – the desired strategy that is communicated to them," Professor d'Arcy explains. "Standard setters and legislators must bear in mind that adding an additional reporting line, for example from internal auditing to the supervisory board, creates conflicts between different objectives. Apart from the desired effects, this may also lead to unwanted side effects."

Read the study

About Anne d'Arcy

Professor Anne d'Arcy, a native of Germany, is head of WU's Institute for Corporate Governance. She studied business administration at Goethe University Frankfurt, where she also earned her PhD in international accounting. She started her professional career in the listing division at Deutsche Börse. After that, she became head of European Accounting & Disclosure Regulation at Deutsche Bank. In 2006, she was appointed professor of accounting at the University of Lausanne/HEC. In 2010, d'Arcy became a full professor of corporate governance and management control at WU. Her main research interests include the effectiveness of internal control systems, the effectiveness of corporate governance measures, and accounting with a focus on capital markets. Anne d'Arcy publishes her research results successfully in renowned international journals, including the International Journal of Accounting, Accounting, Organizations & Society, and the Journal of International Management. She holds positions in numerous boards and organizations, for example as a member of the scientific board of the German Institute of Internal Auditors (DIIR), as chair of the Schmalenbach-Gesellschaft's (SG) External and Internal Corporate Control working group, member of the SG board, and member of the Austrian Corporate Governance Working Group. For over ten years, Anne d'Arcy served as a member of the Federal Electricity Commission, the Swiss electricity regulator, and last year, she took on positions in the supervisory board and audit committee of Vossloh AG, a German SDAX-listed company.

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