Critical Perspectives on Accounting 25 (2014) 771–782

Contents lists available at ScienceDirect

Critical Perspectives on Accounting

journal homepage: www.elsevier.com/locate/cpa

How can we explain internal auditing? The inadequacy of agency theory and a labor process alternative

Dessalegn Getie Mihret *

Deakin University, Australia

ARTICLE INFO

Article history:
Received 11 August 2012
Received in revised form 21 January 2014
Accepted 30 January 2014
Available online 13 February 2014

Keywords:
Corporate governance
Internal auditing
Labor process theory
Marxism
Risk management

ABSTRACT

This paper draws on labor process theory (LPT) to explain how capitalism creates conditions that give rise to a demand for internal auditing. Internal auditing developed from the metamorphosis of capitalism during the twentieth century, when capital gradually succeeded in institutionalizing structural control of labor processes to address the problem of control in inherently antagonistic capital-labor relationships. In this control context employees, management, and the board of directors are responsible for achieving the required rate of return on capital. With the premise that the literature has not adequately theorized the role of internal auditing in this context, this paper proposes an initial theorization of the role of internal auditing as a mechanism employed by management and the board of directors to control the labor process in the generation and realization of surplus value. Internal audit's assurance services to execute business activities according to management's conceptions, and its advisory services to enhance efficiency and effectiveness, are interpreted within the firm's overarching goal of maximizing the rate of return on capital employed. Future research agenda and methodological considerations are discussed.

1. Introduction

Internal auditing[1] is increasingly recognized as a control mechanism that assists management and the board of directors to accomplish corporate objectives (Gramling et al., 2004, Spira and Page, 2003), as shown by the heightened requirement for internal auditing in the post-Sarbanes-Oxley era (Carcello et al., 2005b; Gramling et al., 2004). Nevertheless, despite its rise as an integral component of the corporate governance fabric of contemporary firms (Carcello et al., 2005a; Sarens et al., 2012), internal auditing remains a neglected area of research (Gendron and Bédard, 2006). This paper evaluates existing and emerging theoretical lenses employed in internal auditing research. In particular it contends that agency theory of the firm (Jensen and Meckling, 1976), the dominant theory informing such research (Adams, 1994; Mihret et al., 2010), fails to adequately explain how internal auditing fits into the control framework of capitalist firms. According to agency theory, management introduces internal auditing and other internal control mechanisms to signal to shareholders that management is properly discharging its responsibility to maximize shareholders' wealth (Jensen and Meckling, 1976). The theory assumes that organizational actions are driven by individuals' pursuit of self-interest, with contracts governing the relationships between management, shareholders, and employees.

* Correspondence to: School of Accounting, Economics and Finance, Burwood, VIC 3125, Australia. Tel.: +61 3 52479246.
E-mail addresses: dmihret@deakin.edu.au, desgetie@yahoo.com

[1] The Institute of Internal Auditors defines internal auditing as 'an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes' (IIA, 2004).

1045-2354/$ – see front matter
http://dx.doi.org/10.1016/j.cpa.2014.01.003

Armstrong (1989) challenged the internal consistency of agency theory on the grounds that it fails to explain why this assumption of maximizing utility is sidelined when third-party monitors—auditors—are to be trusted while being appointed and remunerated by management. Accordingly, he underscored the importance of the dialectic of trust and control in the capitalist system and called for a 'radical theorization of agency . . . [focusing on] control, not contract' (Armstrong, 1991, p. 12). Marxist theorists have criticized this assumption (Hula, 1984, pp. 195–196, 199), arguing that individuals' behaviors cannot be abstracted from the social settings in which they take place. Thus, the Marxist approach recognizes the importance of social (Bryer, 1999a) and cultural (Bryer, 2000) determinations as major influences on decision making (Avineri, 1971). Agency theory ignores structural origins of organizational conflict, 'unequal distribution of access to social and economic resources . . . [as well as] [c]onstructs such as sustained domination, exploitation, and structural contradiction . . .' (Chua, 1986, p. 609). Contrary to agency theory's portrayal of capitalist-agency relationships as unproblematic, contracts that underpin the relationships are characterized by conflict and power asymmetries (Armstrong, 1991; Clegg, 1989; Hunt Iii and Hogler, 1990). While the concept of agency relationship is central in labor process theory (LPT) analysis (Cole and Cooper, 2006), the relationship's problematic nature takes center stage in LPT analysis because this approach recognizes that 'employers and management are faced with the inescapable problem of achieving cooperative activity through antagonistic means' (Armstrong, 1991, p. 6). Thus, from the LPT perspective, controls of capitalist firms emanate from struggles that originate from the antagonistic nature of the capitalist-agency relationship (Hopper and Armstrong, 1991). Consequently, compared with agency theory's choice of micro-economic enterprise as the unit of analysis, LPT attempts to address firm-level research questions in the context of the 'structure, contradiction and crisis' that characterize the capitalist system (Armstrong, 1991, p. 9).

In addition to the limitations highlighted above, agency theory arguments are based on the notion that competitive markets underpin the contracts that establish capitalist-agency relationships. This assumption renders the theory problematic for internal auditing research because the demand for internal auditing is not market driven, since internal audit reports are accessible to neither shareholders nor the capital market. Furthermore, the theory highlights the potentially incompatible foundations of the advisory and assurance roles of internal auditing (Nagy and Cenker, 2002) yet fails to explain *why* internal audit practice continues to encompass both roles (Spira and Page, 2003), thereby underscoring the limited efficacy of agency theory for internal auditing research. Neoclassical economic theories, of which agency theory is a part, also draw on the notion of market equilibrium as a core underlying concept. The Marxist approach—and, by extension, LPT—rejects the notion of stable self-reverting equilibriums (Hula, 1984, p. 200), arguing instead that capitalism is beset by periodic overproduction and crisis.

Corporate governance writers of various theoretical persuasions criticize agency theory and propose alternative perspectives such as stakeholder theory, stewardship theory, and resource dependency theory for governance-related research, which includes internal auditing research. Stakeholder theorists criticize agency theory on its neglect of the firm's responsibility to a broad range of stakeholders other than shareholders (Brennan and Solomon, 2008; Christopher, 2010; Collier, 2008). Nonetheless, stakeholder theory is itself criticized for its predominantly normative foundation, a lack of sufficient empirical grounding (Donaldson and Preston, 1995), and for being in need of major reformulation to enhance its explanatory and predictive efficacy (Key, 1999). Stewardship theory dismisses agency theory's assumption of goal conflict between principal and agent (Davis et al., 1997). As argued above, the assumed absence of agency conflict under stewardship theory is questionable from the labor process theory perspective as well. The resource dependency view is another major theoretical paradigm employed to examine firms' sources of competitive advantage, with research questions not necessarily overlapping with the concern of the present paper. In addition to the broad literature within each theoretical paradigm, Christopher (2010) proposed a multi-theoretical corporate governance framework whereby agency theory is supplemented by stakeholder theory, stewardship theory, and resource dependency theory. However, this approach is no less unproblematic than agency theory considered alone, because the component theories of this combined framework are founded on contradicting premises. Furthermore, the attempt to combine normative and positive theories arguably attenuates the framework's internal logic and its potential to support a coherent research agenda.

In view of these limitations of alternative theoretical paradigms, the present study proposes an initial formulation of LPT (Braverman, 1974; Bryer, 1994, 2005, 2006a, 2006b; Burawoy, 1979) to theorize the role of internal auditing in the multi-layered control framework of corporate governance, which connects employees, management, the board of directors, and shareholders. Bryer (2000, 2005, 2006b) drew on Max Weber's and Karl Marx's concepts to develop the notion of social control of the firm (by shareholders as a group) whereby the board of directors and management are responsible for maximizing the wealth of shareholders, and this responsibility is transmitted to employees. This notion of control makes the firm responsible for earning the required rate of return on capital which is enabled by the framework of controls that guide the firm's activities and decisions. This paper uses the history of internal auditing in the USA to explain the demand for internal auditing in this control context of firms. Nevertheless, the paper is neither an extensive formulation of a labor process theory of internal auditing nor a detailed test of it. The paper's value rests in its potential to stimulate debate by identifying pertinent issues and framing a research agenda.

The remainder of the paper is organized as follows. The following section develops the theoretical framework of the paper by outlining LPT and the evolution of techniques invoked to address capital-labor tensions of twentieth century capitalism. Section 3 analyzes the role of internal auditing as a labor process control mechanism using insights derived from LPT. Section 4 presents a discussion and draws research implications of the paper, and Section 5 concludes the paper.