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

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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.

Keywords – Corporate governance; Internal auditing; Labor process theory; Marxism; Risk management

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1. Introduction
Internal auditing¹ 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., 2009), internal auditing remains a neglected area of research (Gendron and Be’dard, 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.

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)
The theory assumes that organizational actions are driven by individuals’ pursuit of self-interest, with contracts governing the relationships between management, shareholders, and employees.

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. 195-6, 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, b; 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.

2. The capitalist labor process and modern management
   2.1. The capitalist labor process

In its generic sense, the labor process refers to the structure of work, that is, the application of human activity on nature to increase the usefulness of materials to human beings (Bryer, 1994). In this sense, Marx (1867, p. 179) described the labor process as ‘human action with a view to the production of use-values, appropriation of natural substances to human requirements ….’ The conscious application of human effort distinguishes the labor process from the instinctive efforts of non-human creatures. This notion portends that the purposive nature of work necessitates the concept of planning, or imagining the final product of labor, before expending effort to produce the product (Marx, 1867). Under capitalism, ‘the wage-
labor system of commodity production’ (Gordon et al., 1982, p. 18), labor becomes effort expended under the direction of management, with inputs of production provided by owners of capital (Braverman, 1974). Thus, the technical core of the labor process in capitalist firms can be conceived as the planning and execution of work (Braverman, 1974, p. 57), as can also be inferred from a scientific management perspective (Taylor, 1947, p. 28). The labor process comprises the relationships between workers, and between workers and management, in transforming raw materials into finished products. Due to the exploitative nature of the capitalist system, the relationship between management and labor is characterized by management’s interest in maximizing the amount of labor power (i.e., the human potential to work) converted into labor (i.e., actual effort applied in production) (Burawoy, 1979, p. 15, Littler and Salaman, 1982).

The relationship between labor and capital is based on economic interdependence, in which production and sales of commodities serves as a basis to reproduce the social relations of production, that is, ‘a society’s modal relations of economic superiority and subordination that condition the way owners of the means of production extract surplus value [i.e., profit] from labour’ (Bryer, 2005, p. 28, 2006a, p. 370, 2006b). The relationship of workers to the capitalist develops in two stages, ‘formal’ and ‘real’ subordination of labor (Marx, 1867, p. 948-1084). Formal subordination of labor characterizes early-stage capitalism, whereby employees own the methods of production (Clegg, 1981) and are responsible for the means of production and for producing commodities as ‘things’ (Bryer, 2006a, p. 563). Labor’s ownership of production methods signifies that maximizing profit rests on the capitalists’ ability to extend working hours. On the other hand, real subordination relates to advanced capitalism (Marx, 1867, p. 948-1084), in which labor is held responsible for both the creation and realization of surplus value (Bryer, 2006a, Littler and Salaman, 1982), measured by increased rate of return on capital employed. That is, labor is responsible for producing not only goods and services but also capital itself, in other words, earning the required rate of return on capital (Bryer, 2005, 2006a). The capitalist owns both the means and the methods of production, and management acts as the agent of capital to direct and control labor. This ownership enables the capitalist to devise production methods that enhance productivity of labor to accelerate the accumulation of capital (Clegg, 1981). Such a relationship entails the development of institutions ‘that organize, transform, or repress struggles over relations in production and relations of production at the level of the enterprise’ (Burawoy, 1979, p. 24).

Owners of capitalist firms aim to valorize capital by using management as the agent to continuously increase surplus value through the use of labor (Marx, 1867). Valorization is achieved by using capital, which is ‘money invested in production for profit’ (Bryer, 1995, p. 688), to buy commodities, and then transforming them to other commodities for sale at higher prices (Marx, 1978). This concept is presented in Marx’s circuit of industrial capital as: \( M \rightarrow C \rightarrow M' \), where M is the original capital invested; C represents commodities purchased for input to production; and M’ is the money generated by selling the commodities produced. This circuit is expanded as M—C (MP, LP)... (P)... C’—M’ = M + \( \Delta M \). That is, the commodity bought as input comprises the means of production (MP) and labor power (LP) employed in the production process (P) to produce new commodities C’ for sale at higher prices (M’) than the original capital invested (M). The difference between M’ and M (i.e., \( \Delta M \)) becomes surplus value, which the valorization process is intended to continuously maximize (Bryer, 2006b; Foley, 1986). Thus, the goal of advanced capitalist firms remains maximizing the ‘rate-of-return on capital employed in production by extracting surplus value from the sale of commodities or services produced by wage labour’ (Bryer, 2005, p. 28) in a process where management acts as an agent of capital to control labor. Following this line of
thinking, this paper adopts Bryer’s definition of the capitalist labor process as ‘the valorization process … that includes all other activities by which capital produces and realizes surplus value’ through the use of labor (Bryer, 2006a, p. 589). The concept of class contradiction underlies the labor process, where class refers to ‘any group of persons occupying the same class status’ (Weber, 2012, p. 424) and ‘class status’ is understood as:

the typical probability that a given state of (a) provision of goods, (b) external condition of life, and (c) subjective satisfaction of frustration will be possessed by an individual or a group. These probabilities define class status in so far as they are dependent on the kind and extent of control or lack of it which the individual has over goods or services and existing possibilities of their exploitation for the attainment of income or receipts within a given economic order. (Weber, 2012, p. 424)

The class-based, exploitative nature of the relationship between management and workers entails class conflict (Bryer, 2005, 2006b). Class conflict co-exists with consent in capitalist social relations of production (Bryer, 2005, p. 28), since ‘individual workers cannot resist [the capitalist’s] demand for the required return because this defines the limit below which it refuses to employ capital and hence labour’ (Bryer, 2006a). Consequently, unlike early-stage capitalism which is characterized by a purely contractual relationship between the capitalist and labor, advanced capitalism exhibits complex relationships that necessitate recognizing the interests of labor. Thus, various managerial strategies, including performance-based payment of wages, are employed to align the interests of workers with those of capital. Achieving the goal of valorization in this context can engender risk, which originates, inter alia, from the inherent contradiction between the respective interests of capital and labor. As a result, intervention mechanisms become necessary to reconcile the demands for efficiency and profitability by capital on the one hand and the interests of workers for higher wages and better working conditions on the other (Rose, 1990).

Braverman (1974) and Friedman (1977) emphasized the separation of planning and execution of work under capitalism and argued that this separation fosters the need for rational management approaches and control mechanisms that can manage conflicting labor-management relationships in the absence of direct management supervision of work. The ‘accretion of management control’ approaches in capitalist firms is partly associated with this dissociation of the conception and execution of work (Cooper and Taylor, 2000, p. 557). Braverman also argued that individual tasks are deskilled by scientific management concepts such as standardizing work and using technology, thereby ensuring control of work by management. However, Braverman (1974) has been criticized for narrowly conceptualizing the labor process around the operational (and thus supervisory) aspects of control (Knights and Willmott, 1989; Littler and Salaman, 1982). This conceptualization emphasizes the generation of surplus value, but it neglects how this surplus value can be realized (Cooper and Taylor, 2000, p. 556). The criticism is partly related to Braverman’s theorization of the labor process being based on scientific management and including the concepts of deskilling of labor. However, various writers have underscored the continuing relevance of scientific management concepts to LPT theorization (e.g., Cooper and Taylor, 2000) and to contemporary management in general (e.g., Cooper and Taylor, 2000; Hosseini, 1993, Humphreys, 1985; Smith and Thompson, 1998). Scientific management is not supplanted by newer management approaches—such as just-in-time operation, total quality management, and restructuring of jobs (Smith and Thompson, 1998, p. 557)—but it has served as a basis for developing some of the more recent management practices (Cooper and Taylor, 2000).
Braverman has also been criticized for neglecting the significance of worker resistance (Armstrong, 1985) and of responsible autonomy in labor process control. Later LPT writers (i.e., Burawoy and Friedman) have redressed this neglect (Smith and Thompson, 1998, p. 559). Furthermore, Armstrong (1989) critiqued Friedman’s treatment of direct control and responsible autonomy as ‘static alternatives’, and argued instead for the importance of the dialectic of trust and direct control in the labor process. The relative emphasis of the accounting literature under LPT on extracting surplus value rather than realising surplus value through sales of commodities (Armstrong, 1985, 1987) has been addressed by more recent works (e.g., Bryer, 2005, 2006a) that consider both internal and external control imperatives of firms within an integrated framework in which increased rate of return on capital is invoked as a measure for increases in surplus value.

2.2. Transformation of labor process control approaches during the twentieth century

Analyzing the transformation of the capitalist labor process and the shift in the associated control mechanisms during the twentieth century enables us to understand the context in which internal auditing has emerged as a separate function in organizations. This function was formalized through the establishment of the Institute of Internal Auditors (IIA) in the USA in 1941 (Ramamoorti, 2003). The labor process in the USA developed through three phases (Gordon et al., 1982). The first involved proletarianization, in which labor was bought and sold, with workers having control over the labor process. The second phase, spanning the late nineteenth century to the 1920s, witnessed the homogenization of labor and its control through direct supervision by foremen. The third phase, subsequent to the 1920s, saw the segmentation of labor into several dimensions thereby rendering direct management control of labor impractical. It is in this later stage of the labor process development that internal auditing developed as a separate organizational function, arguably along with the imperative to successfully manage the more ‘distant’ labor process and address the risk of failure to generate and/or realize surplus value. Similarly, Friedman (1977) analyzed control of the capitalist labor process in three phases with time periods broadly consistent with those of Gordon et al. (1982). He characterized the late 1870s to 1914 as the rise of managerialism in the form of Taylorism and Gilbreth’s motion study, along with increased size and complexity of business. Understanding the limitations of direct control of labor in the earlier phase facilitated the rise of ‘flow production’ in the second phase, i.e., 1914 to 1945, that enabled mass production with reduced need for direct management supervision of workers. He then described the post-1945 period as one in which labor union resistance increased and management introduced ‘responsible autonomy’ as a control strategy (Friedman, 1977, p. 101).

Management practices were substantially transformed from the late nineteenth to the early twentieth century by scientific management thinking (Johnson and Kaplan, 1987). The LPT literature and the broad management literature regard this rise of scientific management (Taylor, 1947) as a significant development in the history of modern management (McKinlay et al., 2009). Scientific management practices focused on measuring and improving the efficiency of individual activities (Johnson and Kaplan, 1987, p. 52). Coordinating diverse activities of large and complex multidivisional firms (such as DuPont Powder Company and General Motors Corporation), and measuring the performance of the entire organization, became important issues in the early twentieth century. Return on investment became a performance measure linking firm performance to capital invested (Johnson and Kaplan, 1987, p. 11, 43, 57). In Johnson and Kaplan’s (1987, p. 65) words, ‘[t]he efficient and effective management of capital itself eventually became a driving force in the firm.’ This
notion of performance is consistent with the LPT argument developed in the preceding section of this paper based on Bryer’s (2006a) formulation of the labor process theory. Complex multidivisional firms that emerged during the early twentieth century also employed internal monitoring and control mechanisms such as ‘internal audit’ (Johnson and Kaplan, 1987, p. 99) to ensure that managers at various hierarchies contribute to achieving the overall goal of the firm.

The increased complexity and size of corporations (Johnson and Kaplan, 1987) also witnessed the separation of management and ownership of firms (Berle and Means, 1932). Such developments produced new control imperatives that augmented the demand for control mechanisms such as internal auditing (Brink, 1947). These mechanisms became necessary to deal with the risk of failing to achieve organizational goals, due to possible loss of control of the organization or the potential pursuit of sub-goals by individual divisions (Johnson and Kaplan, 1987). Furthermore, the accounting abuses of the 1920s (Previts and Merino, 1979) and the decline in productivity during the Great Depression (McElvaine, 1993, p. 17) significantly contributed to the emphasis on audited financial statements and heightened the attention to investor protection. This emphasis is shown by the formation of the Securities and Investments Commission in 1934 (McElvaine, 1993; Previts and Merino, 1979). As argued earlier in this paper, the emphasis on investor protection affirms the centrality of management responsibility to shareholders, which also extends internally to employees of the organization.

Furthermore, the increasing complexity of capitalist enterprises fostered the separation of the conception and execution aspects of business activities, although examples of such separation also existed in earlier, less complex organizations. Separation of these two aspects of work asserts the division into ‘manager’ and ‘managed’, which can promote an antagonistic relationship between labor and management (Braverman, 1974, pp. 67-8). A complex labor process requires mechanisms for coordinating organizational activities and the use of rules— a term used here in a broad sense—which themselves are historically constituted and embedded in how the organization operates. Rules serve as ‘the fundamental organizing principles underlying decisive breaks in or interventions into control of the labor process’ (Clegg, 1981, p. 546). In this framework, where management acts as the agent of shareholders to control labor and maximize its efficiency (Braverman, 1974, p. 16), the conception aspects of work are specified within the framework of such rules, inscribed as they are in policies, procedures, plans, programs, and budgets. Therefore, the execution components of work are evaluated according to the standards that the framework provides. Although the labor process is undertaken within distinct organizational boundaries, the external conditions of ideological and political institutions also influence production relationships (Burawoy, 1979, p. 25).

The significance of external influences such as the market and the state (Burawoy, 1983) suggests that management has incomplete control over labor. That is, externally imposed rationales could determine approaches to controlling the labor process (Braverman, 1974). Laws and regulations delimit the boundaries of acceptable and desirable activities in the effort to achieve organizational goals (Thompson, 1967). Increased market competition also compels employees to accept heavier work pressures and consent to norms set by management (Smith and Thompson, 1998). The increased role of labor unions in the twentieth century (Friedman, 1977; Gordon et al., 1982) and respect for legislated minimum worker rights (Burawoy, 1979) undermined the role of coercion as a management strategy because arbitrary firing of workers would be challenged by unions. Consequently, the
practice of collective bargaining, which presents conflict in a framework of negotiations—
whereby capital and labor compromise on their respective objectives—took center stage in
capital-labor relationships. This system, in turn, transformed control into a hegemonic form,
whereby the ‘industrial citizen’ is formed with rights and obligations (Burawoy, 1979, p. 110). The dialectic of conflict and consensus characterize the terrain of labor process control
(Armstrong, 1989) in this context. Such compromises vitalize the ‘system of [internal]
government’, that is, organizations’ internal policies and procedures and control systems such
as accounting (Spira and Page, 2003) that serve to control the labor process. These
institutions gain relative autonomy from both management and labor, and get inscribed in the
employment contract (Burawoy, 1979, p. 116-117). While these control systems serve to
enhance control of the labor process (Bryer, 2006a, pp. 563-4), these controls still need
assurance services, a practice which Power (1994, p. 300) refers to as the ‘control of control’. Internal auditing is a control mechanism for such institutions.

Therefore, this paper argues that the transformation of approaches to labor process control in
the twentieth century resulted in a shift away from direct control through foremen. This shift
eliminated the personalized nature of the relationship between supervisors and labor, which
was supplanted by more bureaucratic forms of control (Burawoy, 1979; Edwards, 1979). It
could be argued that such changes facilitated an increased demand for internal auditing to
assist management and the board in ensuring compliance with bureaucratic controls.

2.3. Corporate governance and multiple control levels of the firm

Labor process control takes place within the framework of corporate governance. Thus, any
theorization of internal auditing needs to consider the underlying concept of corporate
governance. The Organization for Economic Development and Cooperation (OECD) defines
corporate governance as ‘a set of relationships between a company’s management, its board,
its shareholders and other stakeholders .... Good corporate governance should provide proper
incentives for the board and management to pursue objectives that are in the interests of the
company and its shareholders and should facilitate effective monitoring’ (OECD, 2004, p.
11). Nevertheless, corporate governance arrangements are not uniform across the capitalist
world and the ensuing practices are influenced by local culture (e.g., Macdonald and Beattie,
1993). In some countries, such as Germany, Japan, and France (Macdonald and Beattie,
1993), key stakeholders such as employees and lenders predominate corporate governance,
whereas in countries such as USA, the UK, and Australia shareholders remain more
influential. At a more general level, despite the call on corporations to embrace broader
societal goals than just the economic interests of shareholders (Gallhofer and Haslam, 1993),
the stakeholder focus of corporate governance practices made limited progress. Shareholders
still control major governance decisions such as removal and appointment of auditors and
directors (Macdonald and Beattie, 1993, p. 308). At best, shareholders can be regarded as the
dominant stakeholder whose interests dominate company policy (Turnbull, 1997). With this
understanding, the present paper adopts the shareholder focus of corporate governance
highlighted in OECD principles of corporate governance (OECD, 2004, p. 18). This choice is
made because the American corporate sector, on which the theorization of the paper is based,
still remains largely shareholder-oriented. In the OECD framework, the stakeholder perspective is a means to an end: ‘factors such as business ethics and corporate awareness of
the environmental and societal interests of the communities in which a company operates can
also have an impact on its reputation and its long-term success’ (OECD, 2004, p.12). Further,
’shareholders constitute a valuable resource for building competitive and profitable
companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating cooperation among stakeholders’ (OECD, 2004, p. 46).

Corporate governance comprises multiple control levels emanating from the relationships of the board, management, and operational levels of the firm (Christopher, 2010). From the LPT perspective, Bryer articulated the concept of social control, which encompasses controls on action (Bryer, 2005) and results (2006a), by drawing on management control theory (Emmanuel et al., 1990). The technical aspect of the labor process theorized by Braverman (1974) and his notion of control relate to controls on action. Braverman’s conceptualization focuses on the operational aspects of control (Bryer, 2006a; Littler and Salaman, 1982) that constitute only the surplus extraction component of the labor process. Thus, it fails to integrate the three levels of control in corporate governance. It also disregards the role of accounting in capitalist control, although it recognizes the centrality of the valorization process (Bryer, 2006a). Similarly, Taylorism focuses on individual activities (Johnson and Kaplan, 1987) and emphasizes mainly controls on action without locating individual activities within a broader framework of overall firm control (Bryer, 2006a). Action controls are governed by relevant laws and organizational policies. As emphasized in Friedman’s (1974) and Burawoy’s (1979, 1983) LPT theorizations, the governance of firms occurs within the remit of the law, in which stakeholder interests are also embedded. This notion is explicitly recognized by OECD (2004, p. 21) as well.

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company and its shareholders in terms of reputation effects and an increasing risk of future financial liabilities. (p. 47)

By contrast, controls on results refer to the responsibility of management to earn the required rate of return on capital employed, thereby attending to both the extraction and realization of surplus value (Bryer, 1999a). Achieving this rate depends on both proper controls of action and the impact of external factors on the organization. Burawoy (1979, 1983) took such external factors into account in his analysis of controls. The need to control results emanates from the socialization of capital, whereby owners of capital collectively establish accountability relationships within the firm (Bryer, 1994, 1997, 1999a). Social capital, that is, capitalists as a class (Bryer, 1999a, 2005, 2006a), is represented by the board of directors as a body that links management and shareholders. Audited financial statements serve as a medium to report management’s discharge of its responsibility to social capital (Bryer, 1999b). Consistent with this concept, the coordination of internal and external audit has received considerable attention, especially over the last two decades, due to the understanding that robust corporate governance systems help minimize the devastating impact of corporate collapse (Rusak and Johnson, 2007).

Recall of internal audit’s role in enhancing financial reporting quality underpins this notion. The Blue Ribbon Committee (1999) report presents board audit committees, internal audit, and external audit as a three-legged-stool of corporate governance that ensures the reliability of financial reports. The increased focus on internal and external audit to enhance the effectiveness of the audit committee and the quality of financial reporting quality (DeZoort et al., 2003), especially following the corporate collapses of the 1990s and 2000s (Johnson, 2007), relates to social control imperatives. Bryer’s (2006a) version of LPT integrates the three levels of control by using increased rate of return on capital as a measure
to articulate the generation and realization of surplus value (Bryer, 2006a). This approach also puts both internal and external aspects of firm control within an integrated framework. This framework comprises management accounting and financial accounting (i.e., including external auditing) (Bryer, 2005). The present paper is an attempt to theorize internal auditing within this framework.

3. Labor process control, risk, and internal auditing

The ability of the firm to earn the required rate of return on capital is premised on proper risk management in the labor process. Risk refers to ‘the extent to which there is uncertainty about whether potentially significant and/or disappointing outcomes of decisions will be realized’ (Sitkin and Amy, 1992, p. 11). The present analysis adopts Selim and McNamee’s (1999) definition of risk as ‘uncertainty about events and/or their outcomes that could have a material effect on the goals of the organization’ (emphasis in the original). This definition is consistent with Sitkin and Amy’s (1992) broad definition of risk and the International Federation of Accountants’ (IFAC) (International Federation of Accountants, 2010) definition of business risk 2, which regards failure to achieve organizational goals as the essence of risk. From the LPT perspective, risk comprises the possibility of failure to extract as well as realize surplus value. Organizations govern risk by using appropriate techniques (Aradau and Munster, 2007; Diprose et al., 2008), such as internal controls, as self-insuring mechanisms (Power, 2004). As organizational controls are historically constituted (Clegg, 1981), internal auditing’s assurance and consulting services on controls can also be conceptualized in view of the historical development of organizational rationalities, the pertinent logic of control, the objects of control, and the social relations within which labor process controls are exercised. The increased size and complexity of advanced capitalist firms makes risk management a crucial activity in the governance of organizations (Beasley et al., 2005). Current thinking that risk management is fundamentally a control problem (Committee of Sponsoring Organizations, 1992; Spira and Page, 2003) illuminates the centrality of the services that internal auditing provides to management and the board of directors in the management of risk.

Being efficient and achieving organizational goals, both of which serve as the organizing logic for managing complex organizations (Thompson, 1967), are closely intertwined with the notion of risk management. The management of risk comprises three tasks: defining the organization’s goals, identifying potential drivers of risk, and developing appropriate risk responses (Ritchie and Brindley, 2007; Sitkin and Amy, 1992). The first two components are associated with the general principle of risk assessment, while the response aspect, i.e., control action, is invoked to ensure that goals are achieved (Boehm, 1991). Despite variations in practices across countries (Demidenko and McNutt, 2010), risk management is regarded as a key component of corporate governance that enables organizations to fulfill goals (Subramaniam et al., 2009). A consideration of the definition of internal auditing 3 in view of the definition of enterprise risk management (ERM), which itself is a central notion in the governance of contemporary organizations (Beasley et al., 2005; Gordon et al., 2009),

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2 IFAC defines business risk as “[a] risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.” (International Federation of Accountants, 2010, p. 2)

3 The IIA 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)
clarifies the role of internal auditing as a labor process control mechanism. The focus of internal auditing on organizational objectives, as specified in its definition, is also consistent with the Committee of Sponsoring Organizations’ (Committee of Sponsoring Organizations, 2004, p. 2) definition of ERM as a:

process, effected by an entity’s board of directors, management and other personnel applied in strategy setting, and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

Because the labor process is complex and capitalist firms operate within an external environment, achieving organizational goals can be hampered by risk. Thus, firms endeavor to manage risk through mechanisms that ensure ‘continuity of the past’ (Aradau and Munster, 2007; Diprose et al., 2008). From the LPT perspective, this continuity presumes maintaining the required rate of return on capital employed and thus reproducing the relationships in and of production. Internal auditing can be interpreted as a mechanism employed to control the labor process (Mihret et al., 2010; Yee et al., 2008), managing risk through proper conception and execution of work. Situating the analysis of internal auditing in this arena helps us understand the organizational rationale for internal auditing by theorizing its mode of operation. Both the role and environment of internal auditing have been changing for several decades. Prior to the 1940s, its main function was checking propriety of transactions and records. The development of systems thinking in the 1940s facilitated the emergence of modern internal auditing with a focus on systems evaluation (McNamee and McNamee, 1995). As emphasized in its definition highlighted earlier (The Institute of Internal Auditors, 2010), contemporary internal auditing concerns itself with not only providing assurance on compliance with policies and procedures but also adding value by incorporating a broad scope of activities, including the management of risk (McNamee and McNamee, 1995). This shift in emphasis has resulted from internal and external pressures on organizations that have produced changes in the responsibilities of boards of directors, management, and external auditors (Spira and Page, 2003).

Internal audit’s concern with economy, efficiency, and effectiveness (Al-Twaijry et al., 2003, San Miguel and Govindarajan, 1984), that is, the 3Es, is closely aligned to the notion of risk management in the labor processes of complex organizations. This focus indicates that internal auditing assists management by making visible any potential disturbances in the labor process that could hinder the ability of firms to generate and realize surplus value. Within the framework of organizational policies and procedures that serve as control parameters, internal auditing assists the board and management in managing risk. The assurance aspect of internal audit helps prevent and detect irregularities that could result from mistakes or fraud, while the consulting dimension helps enhance economy, efficiency, and effectiveness (Al-Twaijry et al., 2003) in the labor process. Internal auditing assures workers’ accountability to management (Gramling et al., 2004), which serves mainly to control action in the labor process. Furthermore, internal audit’s role in mitigating wastage of capital through deterring fraud (Beasley et al., 2000; Raghunandan and Mchugh, 1994) originates from the risk management imperative of corporate governance (Spira and Page, 2003). Likewise, the provision of consulting services on how to efficiently and effectively use their resources (Al-Twaijry et al., 2003) helps management address risks ex ante by identifying potentially disadvantageous conditions and recommending solutions. Therefore, from the labor process perspective, internal auditing can be understood as a function that helps maximize surplus value and reduce wastage and any devaluation of capital that could result from fraud, corruption, and inefficiency (Mihret et al., 2010). Competition among capitalist
firms puts pressure on firms to be efficient (Armstrong, 1991, p. 10) and thus ‘compel[s] capital to constantly revolutionalize work’ (Smith and Thompson, 1998, p. 559) and introduce associated control mechanisms such as internal auditing.

The literature highlights the crucial role of internal auditing in enhancing the quality of corporate governance (Cohen et al., 2004; Spira and Page, 2003) and in providing assurance to boards of directors on the management of risk (Carrington and Catasús, 2007; Sarens et al., 2012). The empirical literature provides evidence that companies’ internal auditing budgets are positively associated with the level of risk (Carcello et al., 2005b) and that organizations are committed to managing risk (Goodwin-Stewart and Kent, 2006). Internal auditing is a cornerstone of corporate governance that ‘serves as a resource to each of the other three cornerstones [i.e., board of directors, management and external auditors] of corporate governance’ (Gramling et al., 2004, p. 194). Furthermore, the enactment of the Sarbanes-Oxley Act following the financial reporting scandals of the early 2000s has affirmed the importance of internal auditing in corporate governance (Carey et al., 2006; Christopher et al., 2009). In the Sarbanes-Oxley regime, companies listed with the New York Stock Exchange are required to maintain internal audit departments designed to assist the audit committee in risk management and to ensure that sound internal controls are in place (Carcello et al., 2005b; Gramling et al., 2004). In the LPT framework, both assurance and consulting roles of internal auditing can be conceived as being driven by organizations’ risk management imperatives.

Internal auditing can be considered as a mechanism that provides selective visibility to areas that need management intervention when risks are identified. To address the issue of antagonism driven by divergent interests in capitalist firms, the scientific management approaches invoke accumulating knowledge in the hands of management and dissociating the brain work of planning tasks from their actual execution (Taylor, 1947, pp. 112-3). In addition, the fall of planning in the hands of management provides management with power over the labor process. These changes also produced an associated change in control strategies. The control context characterized by the planning and execution of activities being separated in time and space (Thompson, 1967), coupled with the antagonistic nature of social relationships of capital and labor (Armstrong, 1991, p. 6), necessitates the use of internal auditing as a system of assurance within the organization aimed at reducing exposure to risk. The dimensions of performance, risk drivers, exposures, and the responses that are applicable in the circumstances (Ritchie and Brindley, 2007) are implied in the planning and execution of internal auditing, as suggested by the professional standards (The Institute of Internal Auditors, 2008).

In an organizational context with institutional control mechanisms, the criteria employed to measure organizational success and failure serve as inputs for internal auditors’ work. The planning and monitoring of business activities are intertwined in this context because management is interested in ensuring that the organization is functioning as intended. Also, rational knowledge becomes necessary for carrying out informed intervention (Miller and Rose, 1990) in the labor process to ensure that goals are achieved in the face of risk. As argued earlier, workers and management share common interests in addressing the control problem and ensuring the continuity of the social relationships contained in the labor process (Bryer, 2006a; Littler and Salaman, 1982). Nevertheless, as such common interest does not eliminate contradiction, the use of risk management mechanisms becomes essential. Hence, risk management can be conceived as a control problem in a broad sense (Rasmussen, 1997), a notion supported by the Committee of Sponsoring Organizations (COSO) framework’s
definition^4 of internal control (Committee of Sponsoring Organizations, 1992). In line with this development, management has taken responsibility for internal control systems in recent decades, and boards of directors’ responsibilities have been broadened to encompass enhancing firm prosperity as well as accountability to shareholders. The role of internal auditing was fostered by this shift in top management responsibility about internal control from complying with policies to focusing on significant risks (Spira and Page, 2003). Consistent with this point, internal auditors’ central role in risk management, which is enabled by their intimate knowledge of organizational idiosyncrasies, was one of the premises of the IIA’s stand against outsourcing of internal audit to external auditors (Covaleski et al., 2003; Rittenberg and Covaleski, 2001).

In sum, based on the initial analysis of the history of internal auditing in the USA highlighted earlier, the following labor process hypothesis is proposed for testing and further refinement:

_Labor process theory provides a generic explanation for the role of internal auditing in any capitalist system._

The following section discusses the methodological considerations and issues arising from this initial formulation of LPT as a foundation for future internal auditing research.

**4. Discussion and research implications**

Based on labor process theory (LPT), this paper has attempted to establish how advanced capitalism creates conditions for a twofold demand on the internal audit process: (a) its assurance services on executing activities in the labor process according to management’s conceptions, and (b) its advisory services on enhancing the firms’ efficiency and effectiveness to ensure that the required rate of return on capital is achieved. Control in capitalist firms is conceptualized as social control of the firm by the owners of capital as a group. This notion of control is operationalized through controls on action and results, thereby encompassing both the extraction and the realization of surplus value. It integrates the internal and external aspects of organizational controls within an integrated framework (Bryer, 2006a). The labor process argument adopted in this paper also caters to the concerns of potential rival theoretical paradigms and fills the gaps in these approaches. LPT has been continuously refined (Armstrong, 1989), within the accounting literature and more generally, making LPT attendant to the concerns of competing theories. Specifically, this paper argues that LPT fills an important gap in the internal auditing literature that emanated from the predominant adoption of agency-theoretical arguments for the source of the demand for internal auditing. The asymmetry in agency theory’s arguments of market logic and information render it inadequate for theorizing internal auditing as an internal extension of the firm’s relationship with shareholders.

The argument of this paper is also based on the premise that LPT broadly shares the economic goal of the firm assumed under agency theory. Nevertheless, it recognizes the problematic nature of the agency relationships and pursues the epistemological choice that embraces the importance of structure. This recognition leads to a focus on a holistic analysis of the labor process within the context of the overall capitalist system. Compared with agency theory, which narrowly focuses on principal-agent relations by neglecting stakeholders, LPT

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^4 COSO defines internal controls as ‘a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.’ (Committee of Sponsoring Organizations 1992, p. 9)
provides the conceptual tools to consider the impact of non-shareholder participants, such as the state and labor unions (Boatright, 1994; Burawoy, 1979). This feature of LPT eschews the need for adopting the stakeholder view, which itself is criticized on methodological and empirical grounds (Donaldson and Preston, 1995; Key, 1999). Furthermore, the other potential competing paradigm, which is Christopher’s (2010) multi-theoretical approach, adopts Freeman’s (1984, p. 46) definition of a stakeholder as ‘any group or individual who can affect or is affected by the achievement of the organization’s objectives’ [emphasis added]. Also, one strand of stakeholder theory considers the focus on stakeholders in the management of the firm as a means to an end (Freeman, 1994; Goodpaster, 1991). Therefore, this paper’s focus on organizational goal achievement and its integration of Burawoy’s (1979, 1983) notion of the labor process in its theorization enables the concerns of the stakeholder perspective to be addressed.

The assurance and consulting roles of internal auditing are regarded as complementary rather than contradictory when viewed from the LPT perspective. The assurance role of internal auditing provides feedback on the execution of work in the labor process as preconceived by management, while the consulting aspect provides advice on the conception aspect itself. This second aspect of internal auditing is advocated in the literature as value-added internal auditing (Bou-Raad, 2000; Mihret and Woldeyohannis, 2008) and is emphasized in the definition of internal auditing (Institute of Internal Auditors, 2004) highlighted earlier in this paper.

The role of internal auditing was described above as originating from the development of capitalism and associated management approaches in the USA in the late nineteenth and early twentieth centuries. However, the separation of ownership and control of organizations occurred in Western Europe, especially in Britain and France, earlier than it did in the USA (Hannah, 2007). Similarly, the computation of the rate of return on capital employed was practiced by British capitalist firms earlier than the twentieth century (Bryer, 2005), and internal audit activities, referred to as ‘continuous audit’, were practiced in Britain earlier in the nineteenth century (Edwards, 2012) than the period covered in this paper. These points also demonstrate that the theoretical formulation developed here can be considered generic, despite being empirically grounded in the context of the USA where internal auditing (as presently understood) first became formalized. This qualification also underscores the need for testing and refining the theorization of the labor process of internal auditing proposed in this paper.

The comparative historical method is a suitable methodological approach for testing hypotheses (Skocpol and Somers, 1980) such as the one developed in this paper. As the individual countries in which internal auditing is practiced are unique, comparative historical analysis enables us to test hypotheses and ‘[adjudicate] among [any] rival explanations’ (Collier, 1993, p. 106). This approach was employed by prominent early scholars including Karl Marx, Emile Durkheim, and Max Weber, and remains an established methodological tradition (Lange, 2013; Ragin, 1987). Skocpol and Somers (1980) described the comparative method as one that studies temporal and spatial transformation of phenomena with emphasis on macro-social issues. Similarly, Mahoney and Rueschemeyer (2003, pp. 7-11) noted that causal analysis, emphasis on processes and temporal dimension of phenomena, the use of ‘contextualized and systematic analysis, and interest in big questions’ are the key features of comparative historical analysis. Consequently the appropriate analytic approaches are determined by the chosen comparative strategy. Skocpol and Somers (1980) outlined three methodologies often invoked in comparative historical research: a) macro-causal analysis, b)
parallel demonstration of theory, and c) contrast of contexts. The macro-causal analytical strategy can identify variables that explain a historical phenomenon, often by way of multivariate hypothesis testing. Parallel demonstration of theory tests how theory-based prediction of causal conditions differs across cases. Contrast of contexts analysis systematically compares cases based on ‘ideal-type’ concepts or theory (Mahony, 2004, p. 94). Comparison of phenomena with ideal-type concepts was employed extensively by Max Weber and continues as an established historical methodology (Ragin, 1987). Approaches (b) and (c) described above hold promise for testing the LPT hypothesis proposed in the present paper.

Thus, hypothesis testing through cross-case comparison (Mahoney and Rueschemeyer, 2003) is suggested, since ontological assumptions about empirical reality underlying the hypothesis of this paper are consistent with those of the comparative method. That is, the rise of internal auditing is a developmental reality that happened as a process and that also exhibits spatial variations. For instance, the roles of audit committees and boards of directors have evolved significantly since internal auditing emerged as a separate function. Indeed, current corporate accountability relationships differ from those of three or four decades ago (Keasey and Wright, 1993). At the time internal auditing emerged in the USA, the UK, and other Western countries, audit committees were largely absent or they existed in substantially different forms. Audit committees in their present form have become commonplace since the 1950s and 1980s in the USA and UK, respectively (Keasey and Wright, 1993). Thus, any attempt to theorize internal auditing in view of its history needs to take a longitudinal approach to put practices into their proper historical context. The longitudinal rather than cross-sectional character of processes is a key consideration (Pettigrew, 1992) to account for time and space in the analysis (Pettigrew, 1997). This approach contrasts with those adopted ‘in equilibrium models in economics [including agency theory, in which] the interest is only in the results of the process, not the process itself’ (Pettigrew, 1997, p. 342). The historical method provides a broader temporal context of phenomena, unlike statistical methods that are essentially cross-sectional (Mahony, 2004). Thus, the assumption of the processual nature of the phenomena studied underlies the labor process theorization in this paper.

Being the first major attempt to develop a labor process theory of internal auditing, it is acknowledged that this paper leaves key issues yet to be addressed. First, more empirical literature is needed to analyze the specific ways that processes such as collective bargaining (Zieger, 1994) contributed to supplanting supervision by more bureaucratic control approaches that employ techniques such as internal auditing. Both this particular issue and the overall argument of the present paper call for empirical studies to refine the theorization advanced here. Second, in-depth analysis of individual factors highlighted in this study, such as organizational size, business complexity, attributes of board of directors, and extent of market competition, warrants future research. Third, it needs to be recognized that the rise of control strategies and techniques in the capitalist system is not merely functionalist in origin. Inter-professional competition often spawns new control strategies by occupational groups to garner professional authority (Armstrong, 1985, 1987). Thus, the rise of control mechanisms can be partly attributed to active promotion by occupational groups and competition among them (Armstrong, 1987). For instance, such a development occurred between mechanical engineers (advocating scientific management techniques) and accounting and other business professionals (promoting bureaucratic forms of organizational controls) (Armstrong, 1985; Edwards, 1979). In the context of occupational group competition, deskilling also occurs as elite professionals assign routine tasks to less skilled practitioners and preserve more sophisticated tasks for themselves (Armstrong, 1985; Cooper and Taylor, 2000). Thus, the IIA’s rise as a professional body, and the impact of competition between internal and external
auditors (Covaleski et al., 2003; Rittenberg and Covaleski, 2001), needs to be examined to fully understand the institutionalization of internal auditing as a separate organizational function. Fourth, given the problem of work intensification that characterizes contemporary organizations (Cooper and Taylor, 2000; Taylor and Cooper, 2008; Armstrong, 1985), there is often a potential neglect of performance indicators that deal with workers’ health (Cole and Cooper, 2005). Whether and how internal auditing assists organizations in the management of risk to workers health warrants research.

Interpreting the theorization proposed in this study requires considering the underlying LPT assumption. It is worth noting that a potential limitation of the LTP theorization proposed in this study is the maintained assumption that productive labor is the source of surplus value. Tests of this theorization of internal auditing are, therefore, also tests of Marx's labor theory of value.

5. Conclusion

Advancing internal auditing research entails critically evaluating established and emerging theories relevant to the field. In this regard, labor process theory (LPT) holds promise as a framework to explain the role of internal auditing. In contrast to agency theory, the LPT approach is founded on the premise that controls, rather than contracts, underpin the capitalist agency relationship. Besides recognizing power asymmetries that pervade this relationship, the LPT approach enables a processual study of the development of internal auditing. Internal auditing can be conceptualized as a control mechanism employed to ensure the creation and realization of surplus value by providing \textit{ex ante} advisory services to increase the required rate of return on capital, and \textit{ex post} assurance on executing the labor process as intended. The comparative historical method provides promising strategies for testing the LPT hypothesis that the capitalist system creates generic conditions that give rise to a demand for internal auditing. Despite the attempt to justify the LPT theorization of internal auditing, the value of the present paper rests mainly on its initiation of the debate, formulation of the hypothesis and consideration of further research issues. Thus, this paper concludes by reiterating the need for further research to extensively develop the LPT theorization of internal auditing and rigorously test it.

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