
7. Mechanisms of accountability and governance

Audit, assurance, and internal control

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OVERVIEW

We adopt a historical perspective to understand the current landscape of accountability and governance mechanisms. In adopting assurance as the umbrella concept for audit and internal control, we explore how the notion of accountability (“accountability for what”) and the beneficiaries of corporate accountability (“accountability to whom”) have changed over time, leading to the re-definition of “old” mechanisms of accountability and governance and the development of new mechanisms (“accountability through”). We then provide an overview of recent studies examining how these mechanisms contribute to accountability and governance. We show that the recent trend of combining traditional financial reporting with other reporting activities in an integrated report is questioning the traditional boundaries among the three mechanisms, challenging the attempts to compartmentalize them (“combined assurance”). The chapter concludes by proposing a taxonomy as a tool to help conceptually organize the recent debates on assurance, audit, and internal control practices.

INTRODUCTION

It has been argued that the concept of accountability cannot claim relevance unless it is combined with some form of regular reporting that is externally validated (Normanton, 1966; Bird, 1973). The relationship between accountability and corporate governance has been analysed in Chapter 1 of this *Handbook* by Carnegie and Napier. Regardless of how we interpret this relationship, the capacity of corporate governance to have an impact on real outcomes depends on how it is implemented through processes and practices. Consequently, any attempt to give a comprehensive coverage of the issues related to accountability, governance, and its ramifications would not be complete without including an examination of those mechanisms through which their external validity is supported: audit, assurance, and internal control.

The purpose of this chapter is to explore how audit, assurance, and internal control contribute to accountability and governance. An intuitive and common view associates audit with the certification of financial information, assurance with the certification of non-financial information, and internal control with the internal measures put in place to guarantee that managers act according to existing codes of practice. If these mechanisms function well, “proper” accountability and governance are “guaranteed”. As with any simplification, this viewpoint has its limitations and can be misleading and deceiving. Our purpose is to go beyond this conveniently simplified view and explore how a deeper understanding of the link between these mechanisms of accountability and governance may help us to understand their historical development and envisage some possible future development. We show how the progressive

extension of the boundaries related to “for what” and “to whom” an organization is publicly held accountable has led to a re-problematization of the same concept of assurance (that is, the medium “through” which accountability is certified). This open debate about what assurance means and what it should cover has also generated a new competition in the professional space where traditional auditors are challenged as providers of assurance services (for example, O’Dwyer, 2011; Andon et al., 2015). Financial auditors have reacted to this challenge by taking the lead in the debate on new forms of extended assurance and in the formation of the interdisciplinary teams in charge of providing this extended assurance (Maroun, 2018).


This chapter proceeds as follows. In the next section we develop and propose a conceptual framework through which the concepts of assurance, auditing, and internal control are viewed within the chapter and for purposes of widespread understanding. We discuss the historical context related to these concepts in the third section. In the fourth section we provide an overview of recent research on assurance and the fight for predominance in the new market for extended assurance. In the fifth section we provide a taxonomy that can guide our understanding of the recent debates. Finally, we present concluding comments.

CONCEPTUAL PRELIMINARIES: ASSURANCE AS THE UMBRELLA OF AUDIT AND INTERNAL CONTROL


Any attempt to establish a clear relationship between assurance, auditing, and internal control does not do justice to the complex system of overlaps and intersections that exists among them. However, establishing a conceptual map for these three concepts can serve as a framework to guide the analysis of their historical evolution, discussions, and debates on the boundaries of accountability, and potential future developments in these arenas. At a conceptual level, assurance emerges as a higher-order concept with respect to audit and internal control. Within an organization, audit and internal control ultimately provide assurance on certain aspects of organizational life. Traditionally, audit has focused on the assurance of the contents of financial reports, whereas internal control has focused on assurance of organizational processes with respect to the mission and internal and external codes adopted by the organization.¹

At least two distinct theoretical frameworks may be adopted to interpret assurance as a higher-order concept. On the one hand, we can follow contract theory and view the world as a nexus of contracts between parties whose actions are guided by (possibly bounded) rationality (Milgrom & Roberts, 1992). The enforcement of these contracts often requires information about what has happened in the past and what could happen in the future. Within this framework the fundamental purpose of assurance is to “verify” this information (Christensen et al., 2021; Dye, 2017). On the other hand, we can adopt a broadly defined social perspective (for example, sociological, anthropological, political, and organizational) and envisage the world as an arena where individuals, groups, and organizations interact under the influence of non-rational as well as rational motives. Within this framework the fundamental purpose of assurance is to create “trust” as a key ingredient in the deconstruction of these interactions (Pentland, 1993).

The divide between these two approaches is well known (Cho, 2020; Michelon, 2021; Gendron & Rodrigue, 2021). Within a contract theory framework, assurance is defined by referring implicitly or explicitly to an information system. An authoritative document on

assurance is the International Standard on Assurance Engagements (ISAE) 3000 issued by the International Auditing and Assurance Standards Board (IAASB, ) which advises readers:

In conducting an assurance engagement, the objectives of the practitioner are:

- (a) To obtain either reasonable assurance or limited assurance, as appropriate, about whether the subject matter information is free from material misstatement;
- (b) To express a conclusion regarding the outcome of the measurement or evaluation of the underlying subject matter through a written report that conveys either a reasonable assurance or a limited assurance conclusion and describes the basis for the conclusion; and
- (c) 

This definition assumes the existence of an objective reality (the subject matter) that is communicated as “information” with the possibility of being misstated. The possibility of objectivity is evoked by the reference to a “measurement” activity.

In our view, this is reflective of information economics models. A crucial element of these models is the verifiability of messages. The less verifiable the message, the less likely the possibility of a meaningful communication between the sender and the audience. Hence, often these models assume away the possibility of cheating, using the assurance on financial reporting provided by accountants and external auditors as a justification (Dye, 2017).

If we consider the literature that has adopted what we call a social approach, Smith et al. (2011, p. 426) state that “[t]he essence of ‘assurance’ is that the information provided by companies is deemed more credible if it has been subjected to an independent examination by external third parties”. The emphasis apparent is on the actors involved in the assurance process rather than on the object of it. The structured and codified interactions that take place among these actors have been effectively described as interaction rituals aimed at providing (re)assurance on certain aspects of organizational life (Pentland, 1993; Power, 1999).

The conceptual relationship between audit, internal control, and assurance can be interpreted as one of a means to an end, where audit and internal control are tools to reach assurance (COSO, 2013; Zhou et al., 2020; IAASB, 2021). Two official documents substantiate this:

As the basis for the auditor’s opinion, this standard requires the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. (IAASB, 2021, para. 10)

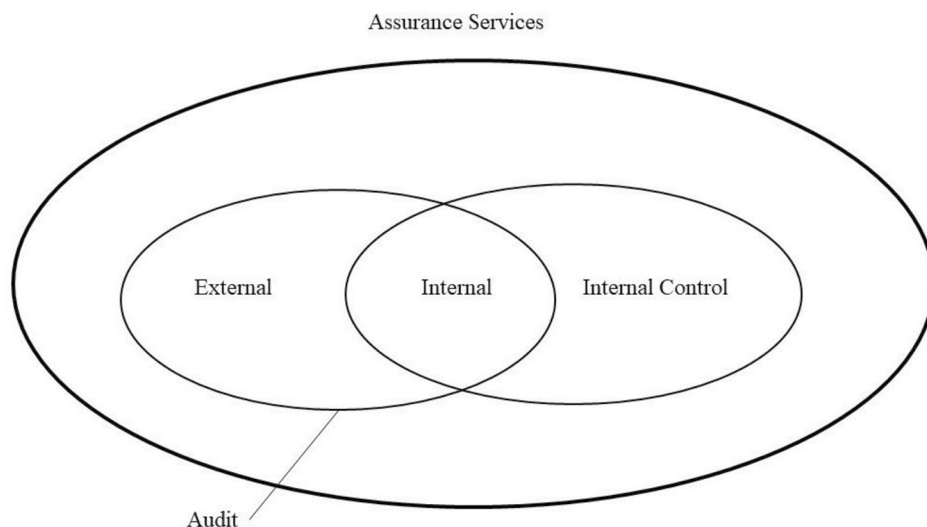
Internal control is a process, effected by an entity’s board or directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance. (COSO, 2013, p. 3)

In both cases assurance is what is “obtained” or “provided” through audit or internal control.

As stated in the IAASB definition, “audit” refers to assurance of financial statements (Hasan et al., 2005), whereas the term “assurance services” is usually referenced as a subject matter other than financial reporting. We argue that this creates an artificial divide between these two categories, ignoring that external audit is itself an assurance engagement. This is due to a rhetoric that presents “assurance services” or “other assurance services” as an extension or as a complement to the “audit service”. We problematize this position later in the chapter, while looking at the historical evolution of the demand for assurance services other than audits because of the evolution of the concepts of accountability and corporate governance. Some confusion may also exist between internal control and internal audit. However, if we

accept that audit refers to financial services, then we can delineate internal control as a concept broader than internal auditing even if they are clearly related (Maijor, 2000).

A visual representation of the conceptual hierarchy discussed above is presented in Figure 7.1.



Source: Authors.

Figure 7.1 Conceptual hierarchy of audit and assurance services

THE HISTORICAL EXPANSION OF THE CONCEPT OF ASSURANCE

The present debate on the boundaries of accountability for companies and the mechanisms better suited to implement it has not developed in a vacuum. It has profound historical roots. To present the historical development of audit, internal control, and assurance, we complement the conceptual map introduced above with the framework proposed by Porter (2009). Her focus of attention is on the evolution of two fundamental dimensions of accountability: accountability to “whom” and accountability for “what”. We intersect these two dimensions with a third one: accountability “through” (that is, to signify which mechanism(s) are used). Given that our focus in this chapter is the third dimension, we simplify the scheme proposed by Porter (2009) into three historical periods: pre-1950s, 1950s to 1990s, and post-1990s. We focus on the UK and the US because these are the countries where the most important shifts in the scope of accountability and governance took place and because of their influence in shaping accountability and governance practices around the world (Boussebaa, 2015).²

Pre-1950s: Financial Audit Dominates the Scene

The need to give account can be traced as far back as the origin of transactions and the need of the owners of economic resources to monitor the activities of those to whom such resources were entrusted (Imhoff, 2003; Power, 1999; Watts & Zimmerman, 1983). Although there is evidence of the conduct of audits of financial matters in the context of manors and states in medieval times (Jones, 2008; Kozub, 1994), the modern idea of audit in the context of financial reporting gains ground with the development of business corporations (Flesher et al., 2005; Watts & Zimmerman, 1983).³ More specifically, the separation of control and ownership in railway and banking companies in the UK in the 19th century generated the need for managers to be accountable to shareholders (“to whom”) for the financial capital provided to the company (“for what”) (Harris, 2013; Napier, 2010; Power, 1999). This prompted a “natural stimulus” for some form of assurance whose main purpose was “to attest”; that is, verify the “truth and fairness” of the financial accounting records (Power, 1999, p. 17; Napier, 2010).

The scope of the financial audit function and the identity, characteristics, qualifications, and responsibilities of those in charge of these audits were problematic from the start. Audits of financial matters were voluntary, closely related to bookkeeping (that is, auditors checked the accuracy of the accounts, therefore the contents of financial statements were verified and guarded against fraud), and performed by shareholders appointed as *amateur shareholder auditors*. The Joint Stock Companies Registration and Regulation Act 1844 included the requirement of mandatory audits (Harris, 2000, p. 284; Napier, 2010) and the Companies Clauses Consolidation Act 1845 further prescribed the governance rules of future corporations, including auditing provisions. Regarding “who” was qualified to act as an auditor, the 1845 Act stated that “every auditor shall have at least one share in the undertaking; and he shall not hold any office in the company, nor be in any other manner interested in its concerns, except as a shareholder” (Companies Act, 1845).

The rationality of this early requirement on the eligibility of an individual to hold office was that, if a financial audit was performed in the interest of the shareholders, then a shareholder had the best incentives to perform it properly. The 1845 Act also opened the possibility of employing external, professional accountants assisting *amateur shareholder auditors* in conducting the audit (Companies Act, 1845; Flesher et al., 2005). Thus, the issue of “who” should be the audit providers (shareholders or external professional accountants) was on the table. Over time, *amateur shareholder auditors* were replaced by professional accountants and by the end of the 19th century around 90 per cent of public companies were audited by professional accountants (Matthews, 2006).

The auditing provisions of the 1845 Act were repealed by the Joint Stock Companies Act of 1856, which made auditing arrangements optional (Napier, 2010). A mandatory audit requirement for joint-stock companies was introduced again by the British Companies Act of 1900⁴ but the Act did not specify who was supposed to provide audits (Chandler & Edwards, 1996). It is with the Companies Act of 1947 (which was immediately consolidated into the better-known Companies Act of 1948) that every limited company was required to have an audit opinion issued by an independent professional auditor stating whether the financial statements of an entity gave a “true and fair view” (Napier, 2010, p. 263; Power, 1999), thereby formally recognizing the role of professional chartered accountants as the only eligible providers of financial audits. It is difficult to determine whether this outcome was the result of increasing demand for accounting and auditing services generated by the development of

business corporations or if it was due to a successful self-promotion strategy implemented by the nascent profession of accountants and auditors itself. However, there is strong evidence in favour of the active role played by the profession in this process (see, for example, Maltby & Chandler, 2020; Matthews, 2017).

The historical development of financial audit and its appropriation by professional accountants in the US has many similarities with the UK. As in the UK, auditing became popular after the incorporation laws (Flesher et al., 2005). The increasing number of corporations and the wave of mergers in the 1890s led to an increase in the demand of audits, which were done primarily by bookkeepers and whose main objective was the detection of fraud and error. By 1926 more than 90 per cent of industrial companies listed on the New York Stock Exchange were audited (Zeff, 2003), but the direction and scope of auditing was still determined by auditors themselves (Levy, 2020). The debate on “who” should be legitimized as audit providers was open until the 1930s. At that time, businesses were more in favour of independent audits performed by professional accountants than any alternative of government intervention (Previts & Merino, 1979).

After the stock market crash of 1929, the US Congress “became convinced that [the crisis] was due, in part, to the lack of meaningful reporting requirements to protect investors and creditors” (Imhoff, 2003, p. 117). The passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 established the Securities and Exchange Commission (SEC) and the new regulation of public company auditing. This was the first step towards further guidance on auditing procedures and the audit report (Levy, 2020). Both these Acts were aimed at regaining public confidence in the capital markets (Imhoff, 2003). These regulatory changes illustrate the evolving nature of the notion of “accountability to whom”, as the new rules extended the accountability domain beyond the boundaries of the company (directors and/or existing shareholders) to include potential investors.

In summary, since the mid-19th century until at least the early 1960s, the scope and objectives of financial audits changed from verification of financial statements and the detection of error and fraud to providing assurance as to whether the financial statements offer a *true and fair view* (for example, Edwards & West, 2021). In the UK, it was possible to produce a kind of “doing the books audit” (Matthews, 2006) while maintaining, legally and publicly, auditing as a function separate from accounting. Furthermore, during this period there is evidence of auditors as providers of “continuous audits”, understood as a kind of non-audit service supplied by the auditors for top management, that focused mainly on employee fraud (Edwards & West, 2021). Hence, auditors were successful in offering a broad range of services, including bookkeeping, auditing, and non-auditing services. In this context, independence was a contentious issue and many of the elements of the present-day controversy on auditor independence were present in the debate (Chandler & Edwards, 1996; Edwards & West, 2021; Maltby, 1999; Maltby & Chandler, 2020).

From the 1950s to the 1990s: Internal Control Enters the Scene

While the role of internal control has been documented as early as 3400 BC (Lee, 1971), it was not until the early to mid-1900s that internal controls were formally recognized in accounting publications, including textbooks (Kester, 1922). The impetus for a change in scope of accepted accountability and governance mechanisms came from the US. The recognition and definition of internal controls was first provided by the American Institute of Accountants

(AIA) in 1949. At this time, the AIA recognized that because of changes in business (for example, increases in size and complexity), auditors would no longer be able to reasonably examine all transactions and they would need to rely on management's representations (Hay, 1993). To do so, an assessment of internal controls employed was requisite. With these matters in mind, the AIA provided the first definition of internal control as:

[T]he plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. (AIA, 1949, p. 6)

In the 1950s, other countries began to formally recognize and discuss internal controls. For example, requirements were issued on the evaluation of internal control in Australia in 1951 and in the UK in 1953 (Hay, 1993). In 1953, the Institute of Chartered Accountants in England and Wales (ICAEW) broadly defined internal control as "including the whole system of controls, financial and otherwise, established by the management in the conduct of the business, including internal audit, internal check and other forms of control" (ICAEW, 1953). The definitions of internal controls contained elements of the AIA definition and broadly included administrative and financial controls (Wilson et al., 2014). These broad definitions prompted a debate on the scope of action of professional accountants' and auditors' responsibility together with concerns about legal liability (Hay, 1993). Accounting regulatory bodies reacted by providing additional guidance that auditors should focus their work only on *accounting* controls (AICPA, 1958).

The fight against fraudulent reporting prompted a series of initiatives that are important to understand how the boundaries of assurance and accountability have been constantly questioned and expanded through time. In the US, the National Commission on Fraudulent Financial Reporting (NCFRR, later renamed Committee of Sponsoring Organizations of the Treadway Commission, COSO) was established in 1985 by the AICPA and other accounting bodies. It found that fraudulent financial reporting could result from management control and not just internal accounting controls (NCFRR, 1987). Hence, in 1992, COSO produced its first definition of internal control together with a proposed framework for internal control. This definition became widely recognized and accepted worldwide.⁵ In 1995, the American Institute of Certified Public Accountants (AICPA) adopted this new definition of internal control, in full, within Statement on Auditing Standards No. 78 (AICPA, 1995).

In the UK, the Committee on the Financial Aspects of Corporate Governance published a report, known as the Cadbury Report (Mallin, 2006), which recommended that company directors should make an internal control statement and auditors should report on the effectiveness of the statement (Cadbury Report, 1992). While the central components of this report were voluntary, the London Stock Exchange required companies to follow the "comply or explain" principle (Arcot et al., 2010). With this "voluntary" requirement, the UK led the way in promoting the internal control regulation of management's and auditors' attestation of internal control. At the same time, other organizations worldwide began to broaden their definitions of internal control as they sought to comply with changing regulations (Spira & Page, 2003).

The emergence of a focus of internal control has caused companies to re-evaluate whether bookkeeping and financial reporting are the only tools to implement accountability (accountability "through"). Moreover, it has also pushed companies to re-evaluate the role and scope of

the audit. During this time period, societal and regulatory pressure started to push the boundaries of audit beyond financial accounting to assurance that was generally based on COSO's broad definition of internal control.

Post-1990s: From Audit to Assurance

Audit under scrutiny and the regulation of internal control

With the end of the 1990s and the turn of the century, the debate on audit and internal control as mechanisms of accountability and governance was reinvigorated. A new wave of scandals in Europe (for example, BCCI, Maxwell), the US (for example, Enron, WorldCom), and Australia (for example, HIH Insurance, One.Tel) prompted a new round of public debate on the usefulness of the financial statement audit (Coffee, 2006). On the one hand, the investigations and official documents produced during this period mentioned the "audit expectations gap", the auditors' responsibility for the detection of fraud, and auditors' independence as major issues facing the audit profession. On the other hand, management responsibility for establishing adequate systems of internal control emerged as a key theme. The US Congress responded with the Sarbanes-Oxley Act of 2002 (SOX – USHoR, 2002).

SOX instituted numerous changes that have dramatically impacted the audit profession, the provision of audit services, and the structure of the US market (DeFond & Lennox, 2011). First, it ended the profession's self-regulation and governance through the creation of the Public Company Accounting Oversight Board, which is the body in charge of inspecting, investigating and, whenever appropriate, sanctioning audit firms for audit failures. Second, it introduced several stipulations designed to enhance auditor independence (for example, a ban on the provision of non-audit services and mandatory partner rotation). With respect to internal control, SOX also imposed more stringent attestation requirements than those imposed within the Foreign and Corrupt Practices Act. Companies publicly traded in the US are mandated to provide management and auditor attestation of the organization's internal control system. This new regulation imposes stiff penalties for non-compliance and at its inception relied on COSO's 1992 broad definition of internal control (COSO, 1992; see also USHoR, 2002). The push to extend the scope of accountability for companies ("accountability for what") and to extend the responsibility of auditors was clear. However, after discussions and comments from professional accounting organizations and industry leaders, the SEC determined that the definition applied to internal control would strictly relate to "internal control over financial reporting" (SEC, 2003).

Following the passage of SOX, many countries adopted similar regulations. A common characteristic of these reforms was the dominance of the 19th-century notion of accountability from a shareholders' perspective ("accountability to whom") (Brennan & Solomon, 2008). The foundations for a "more stakeholder-oriented" perspective were already laid out in documents that include the King Report (1994) in South Africa, the Principles for Corporate Governance in the Commonwealth issued by the Commonwealth Association on Corporate Governance (CACG, 1999), and the Principles of Corporate Governance of the Organization for Economic Co-operation and Development (OECD, 1999). Still, it seems that corporate governance policymakers across the world were not ready to embrace a broader view of corporate governance. Pressured by practical problems that included corporate fraud, abusive managerial power, and lack of social responsibility (Letza et al., 2004, p. 242), they reiterated much of the emphasis of previous corporate governance reforms (for example, Cadbury Report) on

“protecting and enhancing shareholder wealth” (Brennan & Solomon, 2008, p. 886). Yet, the emphasis was changing and the debate about corporate governance issues, both in practice and academia, started to focus on the dichotomy between corporate governance as a private matter vs. corporate governance as the result of interactions between various stakeholders (Brennan & Solomon, 2008; Letza et al., 2004; Solomon, 2007).

The assurance explosion

While internal control was becoming an important pillar of financial audits, the 1990s witnessed the emergence of a broader view of accountability. In 1993, KPMG produced its first worldwide *Survey of Sustainability Reporting* (the most recent edition was published in 2020 – KPMG, 2020). This document highlighted the importance of providing non-financial information (“accountability for what”) to non-financial stakeholders (“accountability to whom”). Since then, the provision and assurance of non-financial information has become increasingly important for organizations as well as for the audit profession, becoming a worldwide phenomenon (Edgley et al., 2010; Mori et al., 2014; O’Dwyer & Owen, 2005).

A case illustration helps elucidate the magnitude of the transformation. The 1980 Annual Report of The Coca-Cola Company was a short document (49 pages) focused on the description of the financial performance of the business. Environmental sustainability concerns were discussed briefly: only one (the last) page of the report titled “Other Information” was dedicated to truly non-financial issues and it described the company’s efforts to promote gender and ethnic diversity among its employees. Conversely, the 2020 official Annual Report (Form 10-K) of the same company is a 194-page document. At the top of the report, the company provides, through a separate section of the website called “Sustainable Business,” an 82-page “Business & Environmental, Social and Governance Report”.

This is not an isolated example. According to the 2020 edition of the *Survey of Sustainability Reporting*, the percentage of a worldwide sample of large companies that report on sustainability issues increased from 12 per cent in 1993 to 80 per cent in 2020 (KPMG, 2020). Whether this increase in the quantity of disclosures really improves the communication between companies and their stakeholders is debatable. However, we witness a push for the extension of the boundaries of accountability that is having a profound impact on the scope of assurance services and on the market for assurance providers. Until very recently, reporting on sustainability information was completed on a voluntary basis and no official regulatory framework was available as a guidance. This regulatory vacuum facilitated the proliferation of numerous private initiatives aimed at filling it. In particular, the increasing volume and importance of sustainability reports has raised questions on who should prepare these reports and how and by whom assurance on these reports should be provided.

Since the late 1990s, initiatives, boards, and committees have been developed that have sought to provide solutions to the above two questions. Of particular interest is the International Integrated Reporting Committee (later Council – IIRC). Founded in 2011, it had the purpose of creating a framework that could be used by companies to expand the boundaries of their traditional financial reporting by extending the notion of “capital” from financial to other forms, such as manufactured, intellectual, human, social and relationship, and natural. Their framework, known as the <IR> Framework, was eventually published in 2013 and since then has been voluntarily adopted by companies in 75 countries around the world. Despite this apparent “success”, the <IR> Framework has generated resistance and critics. We will reflect on this in the next section.

Even though the market for the provision of assurance on sustainability reports is still unregulated and the nature of assurance on non-financial (sustainability) information is voluntary, this phenomenon has gained importance in the first two decades of the 21st century. In 2020, 51 per cent of sustainability reports were accompanied by some form of assurance statement or report, compared to 33 per cent in 2005 (KPMG, 2020). In the US, 35 per cent (24 per cent) of the companies in the Russell 1000® index obtained external assurance of non-financial environmental, social, and governance disclosures in 2020 (2019). For the S&P500® companies, the percentage was 44 per cent, up from 29 per cent in 2019 (GA-Institute, 2021).

To summarize, within the accountability domain, historically we have witnessed an expansion of the boundaries of *to whom* organizations are accountable, starting from “shareholder accountability” focused on owners and moving towards “stakeholder accountability” that now may include all the members of society at large (Brennan & Solomon, 2008). There is also a clear extension of the issues on which an account must be given (“accountability for what”) that now go well beyond financial matters, acknowledging the impact that organizations have on the natural world and society. This broader notion of accountability calls for an extension of the assurance mechanisms as well (“accountability through”) that need to embrace an assurance perspective beyond the mere financial audit and a broader scope for internal control.

The debates on *what* and *to whom* should companies be held accountable and *who* should provide assurance on their reports are not new. As described in this section, professionally qualified accountants contested existing shareholders as providers of financial audits in the late 19th century and beginning of the 20th. We also showed how the push to extend accountability beyond financial reporting into a broad definition of internal control has been resisted by professional accountants since the turn of the 20th century. Within this dynamic context, a new push is taking place to extend the boundaries even more, leading to a contest to occupy the “sustainability assurance space” that is being created (Andon et al., 2015). This historical overview showing how the mechanisms of accountability and governance have evolved over time supports the conceptual map presented in Figure 7.1.

THEMES IN EMPIRICAL RESEARCH ON AUDIT, INTERNAL CONTROL, AND ASSURANCE

The historical overview provided in the previous section highlighted some themes that have played an important role in the development of accountability mechanisms. We now present some recent work related to these themes to show the central role that they still play in recent academic debates.

Audit, Corporate Governance, and the Question of Auditors’ Accountability

We have seen that the establishment of mandatory financial audit and internal control was in response to the need to protect existing shareholders from the possibility of misbehaviour by company management.⁶ A crucial theme, which was already present in the 19th-century debate (Edwards & West, 2021), is who external auditors perceive they are working for: shareholders or managers? Recent research demonstrates the existence of “triangular” (external auditor/audit committee/management) rather than dual (external auditor/audit committee) relationships among the participants in the audit process (Compernelle, 2018; Cohen et al., 2002).

This triangular vision of the audit process provides an interesting framework to associate internal control as a key aspect of fraud prevention when the role of management is recognized as one of the crucial determinants of fraud itself.

More generally, the complexity of agency networks present in the audit process has raised the question of to whom auditors are accountable. Auditors have often defended that their engagement contract is with the client firm and that their accountability stops there. However, the object of the audit process (financial and/or non-financial information) is publicly available. Hence, the assurance role played by auditors goes beyond the limits of the organization being audited. Hurley et al. (2019) use an experiment to examine whether changes in an auditors' accountability framework impact audit quality. They manipulated auditors' economic accountability (that is, who hires the auditor: a manager or an independent third party) and auditors' psychological accountability to investors (that is, stating the auditor is hired on the investors' behalf) (Hurley et al., 2019, p. 233). The results indicate that when auditors' economic accountability to managers is removed and replaced with psychological accountability to investors, audit quality is enhanced, irrespective of the third party hiring the auditors. Accountability to investors matters because "in real-world practices ... auditors are informed that the audit committee hires them in the interest of investors" (Hurley et al., 2019, p. 234). The study confirms the importance of the definition of the reference set of stakeholders ("accountable to whom") for assurance providers in shaping their incentives while providing their professional services.

The lack of accountability of audit firms themselves has been an issue of concern for years (for example, SEC, 2002; EC, 2011). In some jurisdictions, these concerns have led regulators to pass laws requesting that audit firms publish the so-called "transparency reports" (for example, in the European Union (EU), European Statutory Audit Regulations, Art. 13 of Regulation (EU) 537/2014). Some recent studies have examined the content and production of audit firms' transparency reports in EU countries and Australia (Deumes et al., 2012; Fu et al., 2015; Girdhar & Jeppesen, 2018; La Rosa et al., 2019; Zorio-Grima & Carmona, 2019). Overall, the findings suggest that while audit firms fulfil *formal* accountability requirements by making these reports available, the contribution of such reports to *substantial* accountability and audit quality is still in question. In fact, there are calls for more research that aims to demystify the "black box" of audit firms to gain an understanding of their culture and organizational climate and how they may impact the quality of the assurance provided.

The works of Thomas Alberti et al. (2020) and Andiola et al. (2020) provide insights about future research on what is known as the audit firm culture (AFC) and how the notion of AFC may influence audit quality. For example, we may question to what extent recent forces such as regulatory pressure may have caused a cultural shift in audit firms towards professionalism (Thomas Alberti et al., 2020). The provocative and critical essay by van Brenk et al. (2022) calls into question the business model of audit firms and the status quo of audits of organizations known as public interest entities (PIEs). They offer some thoughts on the concept of "audit board", conceived as a quasi-governmental organization in charge of PIEs' audits, which, from a public interest perspective, would be a more sustainable alternative.

Humphrey et al. (2021, p. 445) go one step further and question to what extent the statutory financial audit can evolve into "something more consistently valued and socially purposeful". Contrary to our proposal, they argue that "assurance should be treated as a sub-set of audit rather than the other way round, as this provides a broader canvas for conceptual innovation in audit" (Humphrey et al., 2021, p. 447). We see here some interesting contributions to


the debates on the shaping and reshaping of traditional and new audit and assurance spaces (“accountability for what”), as well as on the boundaries of accountability for auditors (“accountability to whom”).

Internal Control: The Importance of SOX

As our historical overview has shown, the first big push to extend the boundaries of assurance provided by auditors beyond financial reporting took place after the introduction of the concept of internal control, especially in the US. Prior to the passage of SOX, internal control data was largely categorized by companies as proprietary and research surrounding internal control in organizations primarily utilized case studies, surveys, and modelling.⁷ As an exception to the primary research methods being used pre-SOX, McMullen et al. (1996) turned to archival data. During the time of their research, management internal control reporting was voluntary. They found that smaller companies with management internal control reports in place were less likely to have financial reporting issues. This result was in line with the belief that internal control was crucial for fraud prevention. As we have seen, this belief played a crucial role in the insurgence of internal control as a key element of the assurance process.


When the reporting requirements of SOX were implemented, all public companies listed on US exchanges were required to provide management reports on internal control and companies with a public float larger than \$75 million were required to provide public auditor attestation on their internal controls. With this new publicly available information, large-scale empirical studies on internal control have become mainstream. While arguments may at times ensue regarding the value of this stream of research, the added transparency provided through internal control regulation has facilitated a better understanding of the assurance process. Specifically, we have learned that smaller, more complex firms are more likely to have weak internal controls (Ashbaugh-Skaife et al., 2007) and that weak internal controls are associated with lower levels of investment efficiency (Lai et al., 2020) and lower levels of social capital (Krishnan et al., 2022). These results have confirmed on a larger scale that internal control and financial audit are intimately connected and that professional assurance on financial reporting cannot ignore internal control processes (Bauer et al., 2020; Bhaskar et al., 2019).

Assurance of Non-Financial Information: Professional Domains and Combined Assurance

We described above  historical expansion of the provision of assurance services from financial audits to assurance of non-financial information. An open debate exists, both in practice and within the regulatory arena, on how and who should provide assurance on these extended disclosures by organizations. For this reason, we focus on studies that have covered the assurance aspect of non-financial and corporate social responsibility (CSR) reporting.

Peters and Romi (2015) investigate the connection between corporate governance and sustainability assurance. They find that the presence of a chief sustainability officer (CSO) has a positive effect on the assurance provision. Moreover, companies with a CSO are more likely to hire consultants as assurance providers. However, in the absence of a CSO, Environmental Committees are more likely to hire auditors. We see here again an emerging complexity in the assurance agency relationship. As in the case of the “continuous audit” of the 19th century (Edwards & West, 2021), if in the assurance relationship the auditors’ priority

is to satisfy management rather than shareholders, the consultancy aspect of assurance (that is, management consulting) gains importance. On the contrary, when the relationship is such that auditors' primary concern is "their responsibilities as guardians of shareholders' interests" (Edwards & West, 2021, p. 264), then the independent external evaluation aspect seems to prevail.

Another interesting study within this research stream is Maso et al. (2020). These authors study the potential effect of CSR assurance on the quality of the traditional financial audit. The authors conjecture the existence of "knowledge spillovers" between the audit and the assurance team, like those studied between the provision of financial audit and other non-audit services such as management consultancy or taxation (Wu, 2006). These spillovers could improve the quality of the financial audit. For example, the CSR assurance team may uncover deficiencies while reviewing CSR-related data (for example, personnel data, supplier details) and  the financial audit engagement team.⁸ Maso et al. (2020) show that the joint provision of assurance for both financial and CSR information by the same audit firm is positively associated with financial audit quality. Thus, there are possible positive externalities in the provision of assurance for financial and non-financial information. This is a strong argument for auditors in their attempt to occupy the new assurance space created by the increased provision of non-financial information.

Michelon et al. (2019) adopt a different theoretical approach. Their investigation focused on formal restatements of information previously published in sustainability reports. In the absence of clear standards on what is good or bad practice, the assurer may have an incentive to highlight the inadequacy of the information provided to create demand and legitimacy for its services. Michelon et al. (2019) support this argument, showing a statistically significant positive association between formal restatements and the presence of formal assurance for the report. This result is consistent with the idea that the increase in the demand for assurance services for sustainability reports is not just a demand-driven phenomenon, fostered by changing attitudes in society towards sustainability issues. Silvola and Vinnari (2021) take this argument a step further with their analysis of the Finnish case. They argue that one category of potential assurers, auditors, has adopted a deliberate strategy (institutional work) aimed not only at occupying the new professional space but also at making sure that sustainability assurance is run in a way that resembles financial audit.

As highlighted in our historical synthesis, in the realm of non-financial reporting a new concept is gaining ground both at the theoretical and practical level: the integrated report. This report aims to present all the areas of an organization in relation to a common mission and vision. The practice of integrated reporting is expanding. Adopting an eclectic theoretical framework, Ackers and Eccles (2015) study the implementation, through the King III Code, of integrated reporting as the model for the periodic reporting activity of quoted companies in South Africa. According to the King III Code, CSR assurance is regulated on an "apply or explain" basis. The authors show that the introduction of the King III Code increased the percentage of companies providing independent CSR assurance within the integrated report. They also look at the identity of the CSR assurance providers. They find a predominance of auditors as assurance providers as opposed to specialized consultants. Interestingly, auditors and consultants appear to provide different levels of assurance. Auditors provide "limited" assurance while consultants provide "reasonable assurance" (ISAE, 3000). However, through a content analysis of the publicly available information contained in the annual/CSR and/or CSR assurance reports of the selected quoted companies, Ackers and Eccles (2015) detect that

users, particularly “uninformed users” (p. 536), have difficulty distinguishing between these two types of assurance.


Zhou et al. (2019) look at combined assurance (CA) as an innovative framework to provide assurance for an integrated report. CA aims to leverage three categories of actors to enhance the credibility of the report: managers, internal assurance providers, and external assurance providers. The outcome of a CA process is a statement issued by a representative body of the organization (for example, the governing body or the audit committee) that describes and certifies the effectiveness of the assurance process. Based on this assurance process the issuing body assumes responsibility for the information provided in the integrated report. Using a South African sample, Zhou et al. (2019) show that the provision of a CA statement is beneficial because it helps to reduce information asymmetry among investors in the stock market.

Maroun (2018) proposes an “interpretative assurance model” that shifts the focus from the objective verification of the underlying data, which characterizes the traditional approach, to the interpretation and analysis of the information of the integrated report. This model requires auditors to improve their understanding of the integrated reporting framework and the strategic systems of the company, to be trained extensively on qualitative analytical techniques which will help them to evaluate the information provided by the client, and to rethink the composition of audit teams. This process is currently dominated by auditors (that is, experts in financial reporting) rather than strategic business management. The model was developed after taking into consideration the views of experts in integrated reporting (both auditors and preparers), thereby omitting the view of other stakeholders that could include environmental groups or regulators.

To summarize, recent research on assurance of non-financial and sustainability reporting documents a progressive occupation of this space by professional auditors at the expense of consultants or specialists. Synergies and complementarities between financial audit and sustainability assurance are exploited to define the object of extended assurance in a narrow sense, which helps auditors argue in favour of their professional legitimacy based on the skills developed to conduct financial audits.⁹ However, is this the only possible way forward?

MAKING SENSE OF THE DEBATES: A TAXONOMY

To make sense of the discourses taking place around the concepts of audit, internal control, and assurance that are highlighted in the previous sections, we propose the use of a taxonomy. In line with the conceptual map provided in Figure 7.1, we consider assurance as a general concept embracing both financial audit and internal control.

We organize our taxonomy along two dimensions. On  hand, and in line with our conceptual section, we can adopt contract (economics) theory as the main theoretical framework, or we can adopt a more eclectic (social) theory approach. On the other hand, we can consider non-financial information as separate and complementary to financial information or we can investigate integrated reporting as a new way to coordinate financial and non-financial information into a holistic approach to corporate reporting. By intersecting these two dimensions we can organize the possible answers to the three questions that have guided our interpretative framework throughout both the historical outline and the review of the recent academic debates: “to whom”, “for what”, and “through which” report is an organization accountable? The taxonomy is presented in Figure 7.2.

	<u>Financial & Non-Financial Information</u>	<u>Integrated Reporting</u>
<u>Contract Theory</u> Assurance as credibility, verification	Multiple messages Multiple stakeholders Assurance reports as a (regulated) market equilibrium Auditors and consultants may coexist	One message Multiple stakeholders (Partial) assurance report as an efficient solution Auditors and consultants may coexist. Auditors likely to dominate
<u>“Social” Theory</u> Assurance as trust, comfort	Multiple messages Multiple stakeholders Assurance reports as symbolic rituals Auditors and consultants coexist and compete in the professional space	One message Society as a collective stakeholder Integrated Assurance report as a sustainable solution Multidisciplinary teams of assurers

Source: Authors.

Figure 7.2 Taxonomy for understanding assurance

Within a contract theory approach, information asymmetry is perceived as an obstacle to the achievement of economic efficiency and to the enforcement of optimal contracts and regulation. In this context, non-financial information disclosure is seen as an additional and separate opportunity to reduce such information asymmetry. It does not have to be coordinated with financial reporting. It simply increases the amount of information available to the economic agents that make decisions related to organizational life. Assurance has the capacity to increase the effectiveness of this communication process and, consequently, improve the effectiveness of such decisions. This is the top-left quadrant of the taxonomy. When an organization is seen as a nexus of contracts involving various stakeholders, multiple disclosure documents are produced for different stakeholders as a part of these contracts. A term like “corporate social responsibility” may acquire different meaning depending on which stakeholders and contracts are considered (O’Dwyer, 2003; Freeman & Hasnaoui, 2011). In this context, the identity of assurance providers does not necessarily matter. What matters is whether assurance improves the enforcement of contracts and economic efficiency.

The disclosure of non-financial information, separately from financial reports, can be studied under theoretical frameworks other than contract theory. This is the bottom-left quadrant of the taxonomy. Legitimacy theory has often been used in this literature. According to this approach, the aim of communicating non-financial information is to gain legitimacy for both the disclosing (client) firms and the assurance providers (Cho & Patten, 2007; O’Dwyer et al., 2011; Patten, 2020). In fact, from this perspective corporate managers and assurers are likely to be accused of “capturing” what should be an exercise of public accountability (Smith et al., 2011, p. 425). The identity of the assurers matters because different professions may have different roles and different levels of hegemony within a jurisdiction (for example, Abbott, 1988; Andon et al., 2015).

The provision of non-financial assurance is one of the jurisdictions where the status of each profession is to be determined. Indeed, it is precisely the fragmented status of corporate communication (financial, environmental, governmental, societal, e-commerce, etc.) that creates opportunities for a potential power shift from more established professions (for example, auditors) to new players (for example, environmental consultants, IT specialists). Whether these potential power shifts are seen as threats or opportunities depends on multiple factors, including how stakeholders and society perceive the new domains. The focus of interest is on the social equilibrium, of which the economic dimension is merely one among others, including the anthropological, sociological, political, affective, emotional, and organizational dimensions.

As mentioned before, integrated reporting is the latest trend in corporate communication and accountability. The way “integrated reporting” is interpreted depends on the theoretical framework adopted. If we adopt a contract theory framework, we are in the top-right quadrant of the taxonomy. Here, the purpose of integrating different types of information in one report is still to improve economic efficiency by facilitating the enforcement of contracts between the organization and its various stakeholders. However, the possibility of sending different messages to different audiences is not available. The same document is presented to all stakeholders. They can obviously focus more on one part of the document than on another, but they are exposed to the whole message. Hence the format and the content of the document depends on the relative importance that the sender of the message places on each stakeholder. The danger here is giving priority to one stakeholder category over the others. In this regard, it is interesting to look at the most popular standardized version of integrated reporting at the time of this writing (that is, the <IR> Framework elaborated by the IIRC). On p. 2 of the <IR> Framework it is stated:

Integrated reporting aims to:

- Improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital
- Promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organization to create value over time. (IIRC, 2021, p. 2)

No other stakeholder is given the same predominance in the document as the “providers of financial capital” and no other purpose is more important than the “creation of value”. It goes beyond the scope of this chapter to discuss at length the <IR> Framework itself.¹⁰ We want to focus on the implications for assurance. If the primary audience of an integrated report are the providers of financial capital, it is reasonable to expect that the provision of assurance on this document will be seen as an extension of the provision of assurance within its financial section. Large companies like Danone (Arjalies et al., 2018; Eccles et al., 2019) have decided not to adopt the <IR> Framework because of its narrow approach. Nevertheless, this approach facilitates the view of non-financial information assurance as a non-financial “audit” (that is, the extension of financial audit techniques and processes to the other parts of an integrated report). Accordingly, auditors are likely to have an advantage over alternative assurance providers. Nevertheless, adopting a contract theory approach to integrated reporting doesn’t have to lead to such a conclusion. Other scenarios are possible depending on how the idea of integrated reporting is implemented (Maroun, 2018; Zhou et al., 2020).

Finally, integrated reporting does not have to be interpreted only within the boundaries (or constraints) of contract theory. A holistic approach to the study of society, nature, and the planet can lead to the adoption of a holistic model of corporate communication. We are now in the bottom-right quadrant of the taxonomy. Decades of critical research in accounting are calling for a new definition of accounting that goes beyond the boundaries of a technical practice concerned with monetary values and financial performance. Carnegie et al. (2021) have taken the challenge to propose this new definition of accounting: “Accounting is a technical, social and moral practice concerned with the sustainable utilisation of resources and proper accountability to stakeholders to enable the flourishing of organisations, people and nature” (Carnegie et al., 2021, p. 69).

This definition serves well the idea that all the stakeholders of an organization are members of the same global society and living on the same planet. No stakeholder category is given priority over another. “Accountability to stakeholders” can be interpreted as accountability to today’s society, nature, and the planet as well as accountability to the future; that is, the planet and the future of the planet as a collective stakeholder. If this is the case, the previously fragmented conversation that was taking place through separate “reports” can be recomposed in a unified discourse that materializes in an integrated report.

This process of reunification of the discourse may have profound implications for assurance as a mechanism of accountability. It could lead to the re-composition of the different realms of assurance provisions into one. Internal and external financial audits, internal control, and sustainability assurance would all contribute to an organic provision of societal trust for the organizational discourse. No pre-existing group of professionals and no pre-existing assurance techniques would appear as “winners” of the competition for professional supremacy. New multi-disciplinary teams would work together to build an assurance report that is likely to be different from any existing, both in terms of format and content. Combined Assurance or “interpretative assurance” (Maroun, 2018) can be seen as first steps in this direction, but it needs to develop outside the boundaries of contract theory to evolve into holistic integrated report assurance.

CONCLUSION

Within this chapter, we have explored how audit, assurance, and internal control contribute to accountability and governance. To do so, we first presented a conceptual map that established assurance as the umbrella embracing at its base audit services and internal control. An overview of the historical development allowed us to see that the subject matter of assurance provision as a mechanism of accountability has been expanding from financial audit to internal control and to a broader set of societal and environmental issues. More specifically, through this historical lens, we show how “accountability for what”, “accountability to whom”, and “accountability through which” have evolved and continue to evolve within the current global context. The malleable and problematic nature of these three dimensions of accountability still generates debates today.

We have reviewed some of the recent contributions in the research domain that contribute to these debates and proposed a taxonomy of potential options for the provision of assurance services in the 21st century. The purpose of the taxonomy is to help continue these conversations. As we have seen, similar situations of critical reconsideration of accepted paradigms

about governance, accountability, and assurance have already taken place in the past and have prompted drastic shifts in practice and regulation. Hence, it is reasonable to envisage important changes taking place in the future sphere of accountability in organizations, including audit firms, as well as in the professional space of assurance providers. These shifts will be accompanied by a reshaping of organizations' communication landscape, both internally and externally.

NOTES

1. Humphrey et al. (2021) propose exactly the opposite; that is, to see assurance as a subset of audit. While we share the same willingness to explore innovations in the audit space, we believe that this can be done within the traditional conceptual order (audit as a subset of assurance) through a new definition of the meanings and processes associated with these concepts. Reversing the order runs the risk of facilitating the attempt of "financial" audit theories and practices to colonize assurance.
2. We recognize the limits of this approach but providing worldwide coverage of the historical development of accountability and governance would go beyond the aims of this chapter.
3. The existence of limited liability corporations was allowed under British law as early as 1553 (for example, Edwards (2019) indicates that the East India Company was granted the royal charter in 1600).
4. The requirements only affected companies raising capital from the public. For details about the origins of private companies in Britain, see Harris (2013).
5. The most recent version of this COSO definition of internal control can be found in the conceptual section of this chapter.
6. The literature reviews and meta-analyses of Hay et al. (2006), Carcello et al. (2011), Hay (2013), DeFond and Zhang (2014), and Hay et al. (2017) provide good summaries of prior archival research on the links between auditing and corporate governance.
7. A large body of this research focused on auditors' assessments of internal control as they relate to the financial statement audit (Ashton, 1974; Gaumnitz et al., 1982; Meservy et al., 1986; Frederick, 1991; Smith et al., 2000).
8. Maso et al. (2020, p. 1255) provides anecdotal evidence of the existence of these knowledge spillovers.
9. Canning et al. (2019), Edgley et al. (2010), O'Dwyer (2011), and O'Dwyer et al. (2011) offer insights into the transfer of financial audit-based methodologies and concepts to new assurance areas.
10. For a study on the emergence of the IIRC and its efforts to promote integrated reporting, see Humphrey et al. (2017).

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