

# Structuring internal audit functions in multinational companies

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## ABSTRACT

During the last five decades, the world has witnessed a dramatic proliferation of multinational companies (MNCs) that has evoked strong interest amongst academic researchers. Despite the acknowledged need to expand internal auditing activities to cover MNCs' diversified operations in multiple countries, only limited research has been performed from an internal auditing perspective. Drawing on institutional theory, this paper aims to add to the existing internal auditing literature by reviewing various international business management frameworks, in order to suggest an appropriate approach for the establishment and management of the internal auditing functions of MNCs. The study looks at the evolution of internal auditing functions in MNCs, examines organizational models described in international business management literature, and concludes that a geocentric approach is appropriate when structuring the internal audit function in a MNC. The argument is presented that geocentricity (which implies careful customization to address local context, while operating within established uniform standards) seems to be an appropriate approach for the organization of the internal auditing function of a MNC.

## Key words

Auditing; internal auditing; multinational companies; globalization; geocentric model; local contexts

## 1 INTRODUCTION

Globalization, which implies cross-border trade and capital flows, and labor integration, has become one of the defining trends in today's world, bringing new opportunities and challenges for the business community (International Monetary Fund 2008). Nowadays companies simply do not seem to have any choice: if they want to expand and remain competitive, crossing the borders is an inevitable step in their development (Purdy & Wei 2014; Bobillo, Lopez-Iturriaga & Tejerina-Gaite 2012; Wiersema & Bowen 2008). In the last four or five decades the world has witnessed a dramatic proliferation of multinational companies (MNCs): according to the estimates of the United Nations Conference on Trade and Development, there has been a sixteen-fold increase in the number of MNCs - from 7,000 in 1969 to 111,000 in 2014 (World Trade Organization 2014:50). The expansion of local and nationally represented companies into global entities has changed the world and reshaped the way of doing business, and has consequently also raised new questions and set new performance standards for business executives.

The rapid expansion of the MNC phenomenon has evoked strong interest amongst academic researchers, who continue to develop various theoretical and empirically tested frameworks, in their efforts to

describe and explain the still rampant proliferation of MNCs (Aggarwal, Berril, Hutson & Kearmey 2011: 558; Vachani 1999:537; Malnight 1996:43; Solvell & Zander 1995:17). But research into MNCs from an internal auditing perspective seems to be limited, despite the fact that various surveys have reported that internal auditing functions have to reposition themselves to represent companies operating on a multinational scale (IIARF 2010:20; Burnaby, Hass & Abdolmohammadi 2009:8). Drawing on institutional theory, the objective of this study is to add to the existing literature with regard to internal auditing in MNCs by suggesting an approach to follow while structuring multinational internal audit functions, and by identifying factors that should be considered in order to perform effectively across borders. Both the suggested approach and the factors to be considered emerged from an examination of pertinent international business management literature.

The developed body of knowledge on MNCs does not yet provide an agreed definition of MNCs, as scholars have their individually preferred, and usually different basic defining characteristics of global companies. Typically, though, these are based on the contribution of foreign sales, assets, and production to the company's total performance, the number of locations abroad in which the company operates, and the number of foreign employees on the payroll, amongst other criteria (Aggarwal *et al* 2011:558; UN 1973:4).

For the purposes of this paper, the definition adopted by the United Nations' Economic and Social Council in 1973 is preferred. This determines a MNC to be an enterprise that controls assets in two or more countries (UN 1973:5). The geographical distribution of the operations of a company has numerous implications for that company, posing challenges to its efforts to organize, coordinate and control its activities in different countries, cultures and contexts (Aggarwal *et al* 2011; Begley & Boyd 2003). These challenges are likely to be equally valid for the internal audit functions of MNCs.

## 2 THE RESEARCH QUESTION AND METHODOLOGY

This study is based on a review of published research literature. It is presented from an institutional theory perspective and considers international business management concepts. It aims to answer the following research question:

*How should internal audit functions of MNCs be structured?*

The remainder of this paper is structured as follows. Starting with the discussion of institutional theory as the conceptual underpinning of the study, it offers an historical perspective of the development of internal audit in MNCs. Drawing on various international business management concepts, an effective approach is then suggested for internal auditing in a MNC, and the factors that need to be considered by directors and managers are discussed. The paper concludes by identifying areas for future research.

## 3 INSTITUTIONAL THEORY

This study is presented from the perspective of institutional theory. This theory is used to understand organizational behavior as set in and influenced by other organizations, as well as broader cultural rules and beliefs (Heugens & Lander 2007). In their seminal work, DiMaggio and Powell (1983) identified three mechanisms through which convergence occurs, as organizations seek to become isomorphic (similar) with their contexts: these mechanisms are categorized as *coercive*, *normative* and *mimetic*. They argue that pressures for conformity exist in a business/industrial field and these result in sets of homogenous organizational forms (DiMaggio & Powell 1983; Lawrence 1999).

Several studies in internal auditing have adopted institutional theory as their starting point (Endaya & Hanefah 2013; Mihret, James & Mula 2010; Arena & Azzone 2007; Arena, Arnaboldi & Azzone 2006; Al-Twajjry, Brierley & Gwilliam 2003). Arena and Azzone (2007), Arena *et al* (2006), as well as Al-Twajjry *et al* (2003) have investigated the development of internal audit departments in companies in Italy and Saudi Arabia, from the perspective of institutional theory, and all considered *coercive*, *mimetic* and *normative pressures* to be relevant drivers, capable of explaining the development of the internal audit functions. *Coercive pressures* originate from formal and informal pressures exerted on organizations, which impact internal audit activity; *mimetic pressures*

make companies replicate the organizational structures and processes of companies perceived as more legitimate; *normative pressures* are associated with the influence exerted by internal auditing's professional bodies (Mihret *et al* 2010; Arena & Azzone 2007; Arena *et al* 2006; Al-Twajjry *et al* 2003).

Regulatory requirements that affect the internal controls of MNCs represent the formal side of *coercive pressures*. Firstly, the laws and regulations of the country of operation may require/compel the presence of an internal audit function. Secondly, the increasing global demand for accountability, transparency, sustainability and social responsibility substantiate internal auditing's value as an important assurance function, that thereby contributes to the stakeholders' demands for ongoing improvements in corporate governance (Thomson Reuters 2013:4; IIA 2012:11; Sarens, Abdolmohammadi & Lenz 2012:191; Soh & Martinov-Bennie 2011:605; Gramling, Maletta, Schneider & Church 2004:195). In addition, internal auditors are expected to provide enterprise-wide assurance regarding internal controls' compliance with various control frameworks, including those of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and specific regulations with extra-territorial reach, such as the United Kingdom's Bribery Act, the United States' Foreign Corrupt Practices Act and the Sarbanes-Oxley Act, and the European Union's Data Protection Directive, amongst others (Stippich & Blackwell 2012: 67; Arena & Azzone 2007:94; Arena *et al* 2006:281; Vanasco, Skousen & Verschoor 1995:23).

Informal *coercive pressures* originate from the need to align internal audit activities with the strategic needs of companies operating globally. The effective performance of an internal audit function is thus dependent on a sound understanding of the environment (in all its business and social nuances), and addressing both its formal and informal pressures (Chambers & McDonald 2013:4; Thomson Reuters 2013:11; Stippich & Blackwell 2012:67). This is acknowledged to be an understanding that is difficult to gain without a physical presence in the foreign location.

Although locally based professional bodies exert *normative pressures* on the development of internal audit departments in certain countries, due to their regional promotional activities (Arena & Azzone 2007; Arena *et al* 2006; Al-Twajjry *et al* 2003), from the perspective of MNCs it is the influence of global professional bodies, represented primarily by the Institute of Internal Auditors (IIA), that informs the formal pressures referred to above.

*Mimicry* refers to the copying of the practices of similar organizations in the same field (Mihret *et al* 2010:228; Arena & Azzone 2007:95; Arena *et al* 2006:280; Al-Twajjry *et al* 2003:512). It has been a common but not universal practice for internal audit functions in MNCs' foreign offices to follow the home-base/head office model (some variations of organizational structures of internal audit functions were also found). In a study on the development of internal auditing in the UK Liu, Woo and Boakye-Bonsu (1997:470) found that UK companies with

multiple international locations tend to choose a divisional structure, with a decentralized system of authority. However, according to PricewaterhouseCoopers (PwC) (2007:16) the emerging trend is the creation of hybrid structures like the "hub and spoke" organizational model preferred by global external audit firms; the corporate hub is located in the home country/head office, with spokes supporting the main areas of operations. This model gives the MNC all the benefits of maintaining an internal audit presence throughout the company, while keeping certain specialized (more costly, and less frequently used) functions at the headquarters. This organizational model allows the MNC to achieve a high level of centralization, while allowing some local autonomy that enables the local operation to respond to location-specific operational issues (Moeller 2009: 285). The organizational anatomy of internal audit is thus likely to resemble the organizational structures of other functions and divisions within a global company, which indicates a response to mimetic pressure. In the next section, a historical perspective on the development of internal audit in MNCs is presented.

#### 4 HISTORICAL PERSPECTIVE ON THE DEVELOPMENT OF INTERNAL AUDIT IN MULTINATIONAL COMPANIES

Even though there is a substantial body of knowledge on the organisational and operational aspects of MNCs (Aggarwal *et al* 2011:538; Vachani 1999:537; Malnight 1996:43; Solvell & Zander 1995:17), research specific to their internal audit functions is limited. This is despite the widely recognised potential of the internal audit function to add significant value to the entity (Murdock 2006:29; Tucker 1998:29). The unique position and ability of internal audit to assist management in the control and coordination of foreign operations seems not to have been leveraged: 50% of US-based MNCs surveyed in 1971 claimed to have conducted no internal audits of their foreign affiliates (AlHashim 1980:38), while in 2010 39% of respondents to a similar survey indicated that their home location internal audit functions perform only some of their organization's global internal audit activities (Stippich 2011:1).

##### 4.1 Pre 2000

Okopny (1985:49), reviewing the then existing literature in the field of international internal auditing, argued that publications available before 1985 were mainly focused on the practical considerations of travelling abroad, although these studies did also emphasize the perceived role of internal auditing as an effective tool to ensure better understanding of international business activities and their inherent risks. Later research was designed to help auditors not only to plan their travels, but also to identify some of the unique challenges they might face when away from their home locations. These challenges included cultural and regulatory differences, country-specific risks and business practices, and the diverse levels of maturity of the internal audit profession around the world, all of which had to be considered at the planning stage of international assignments (Murdock 2006; Tucker 1998; Sears 1994). The home-base model, which represents a centralized internal audit

approach, was thus dominant in the internal auditing professional literature up to the turn of the century.

##### 4.2 2000-2005

While the companies were trying to gain additional competitive advantages through increasing the number and integration of their cross-border operations, the research published at this time was largely devoted to investigating the impact that globalization might have on the internal audit profession, particularly the expansion of the roles and responsibilities of the internal audit function, and the associated changes to the skill set required of the individual internal auditors (Sumners & Soileau 2008:1; Baker 2007:46; Bartolucci & Chambers 2007:64; PwC 2007:13). The progression towards risk-based auditing made internal auditors responsible for the timely identification and assessment of emerging risks, and the challenges a MNC might face in the course of its foreign activities, as well as the evaluation of potential business opportunities that could be capitalized upon through expanded worldwide operations (Bartolucci & Chambers 2007; Zhang 2002).

Another emerging trend in the internal auditing area of the early 2000s, which was attributable to globalization, was the practice of co-sourcing, or partial outsourcing. Contracting outsiders/others to perform internal audit services was acknowledged by practitioners to be a viable business option (IIA 2013:11; Ernst & Young 2010a:9; Serafini, Sumners, Apostolou & Lafleur 2003:65), and its numerous benefits and possible pitfalls were extensively examined (Ernst & Young 2010b; KPMG 2008; Schneider 2008; Van Peurseem & Jiang 2008; Watson 2007; Del Vecchio & Clinton 2003; Serafini *et al* 2003). The most sought-after advantages of the co-sourcing internal audit model for MNCs wishing to expand internal audit coverage of their foreign operations were that local co-sourced organizations could provide industry-specific knowledge and expertise in local legislation and business customs. They were also able to draw on relevant experience in the same industry segment and provide valuable information on country-specific risks, all of which enabled the MNC to respond more effectively to the increasingly stringent demands of stakeholders, without increasing travel costs (KPMG 2008:4; Watson 2007: 29; Del Vecchio & Clinton 2003:34; Serafini *et al* 2003:62).

Although the notion that foreign operations demand specific approaches had some support (Murdock 2006; Zhang 2002; Sears 1994:28), the predominant trend in the early 2000s was still the centralization of the internal audit function. According to a study conducted by PwC (2007:16), 54 percent of respondents expected internal auditing to be based in a central location, with only a few functions existing internationally, while 37 percent of respondents insisted on one central internal audit function being established and maintained in the home country. Thus, barely a decade ago the home-base model for MNCs' internal audit functions was still strongly supported. This deduction was confirmed by Murdock (2006:29), who suggested that at that time "the conventional audit department is centralized and typically located near the company's headquarters".

### 4.3 Beyond 2005

Over the past decade the rapid growth of cross-border business integration has challenged internal auditors to expand their activities to cover diversified operations in multiple countries (Stippich 2011:1; Baker 2007:48; Bartolucci & Chambers 2007:64; PwC 2007:13; Murdock 2006:24; Protiviti 2006:i; Zhang 2002:40). Effective and efficient internal audits of foreign operations could no longer be performed remotely and demanded the physical presence of internal auditors, motivating the establishment of internal audit functions in foreign locations (Moeller 2009:283; Baker 2007:48; Bartolucci & Chambers 2007:65; Murdock 2006:29). More recently, publications in the field of internal auditing have increasingly indicated the need to move internal auditing abroad (Protiviti 2012; Stippich & Blackwell 2012).

In recent years researchers have begun to emphasize the need to expand internal auditing's responsibilities as a result of the growing awareness of its contribution to corporate governance (IIARF 2014:81; Soh & Martinov-Bennie 2011:618; PwC 2007:38; Brody & Lowe 2000:170). According to Sarens *et al* (2012:197), the scale of the international operations of a company is likely to determine the level of involvement of the internal audit function in corporate governance issues. Similarly, the expanding roles and responsibilities of the internal audit function have required the function to expand its essential skills set (Sumners & Soileau 2008:1; Bartolucci & Chambers 2007:66; PwC 2007: 37; Murdock 2006:24).

Performance standards for internal auditors comprise their deep technical expertise (including country-specific knowledge), their ability to adjust to the unfamiliar environment of a foreign country, and their abilities to communicate with stakeholders with a diversity of specific and special interests (IIARF 2014:86; Chambers & McDonald 2013; Murdock 2006:25). Previous studies have identified that the following requirements are crucial for MNCs' internal auditors:

- *Language skills.* Internal audit executives were advised to recruit people with the ability to speak the languages of those countries where they have most operations (Murdock 2006:24; Powell 1993: 54).
- *Diversity and flexibility.* Multinational auditing implies dealing with different ethnicities, nationalities, ages, and cultures. Internal auditors should therefore be able to adapt to different thinking and management styles in order to develop collaborative and mutually beneficial relationships, to understand the local system of values, and to respond rapidly to changing business conditions (Chambers & McDonald 2013:8; KPMG 2008:5, Murdock 2006:29).
- *Continuous learning.* Effective auditors should be able to absorb new information. They should show reasonable knowledge of important international laws covering internal audit issues, international legislation, and compliance rules, and additionally, they should monitor the latest global

developments and changes that might affect the company (Chambers & McDonald 2013:9; Burnaby & Hass 2011:752; Baker 2007:46; Allegrini, D'Onza, Paape, Melville & Sarens 2006:852; McDonald 2003:47; Vanasco *et al* 1995:28).

The movement from a home-base model for internal auditing towards a decentralized model can be substantiated from the perspective of institutional theory, which considers the environment to be the key factor determining the behavior of organizations.

## 5 INTERNATIONAL BUSINESS MANAGEMENT CONCEPTS

The literature stream on MNCs offers extensively discussed and empirically tested frameworks of organizing principles and management systems for established cross-border operations. The fundamental typology of management practices of MNCs was developed by Perlmutter (1969), who identified the following definitive organisational attributes: *ethnocentric*, where the headquarters replicate home country practices for foreign operations; *polycentric*, where local differentiation is recognised; and *geocentric*, where a collaborative approach between geographically dispersed locations is effected, which enables the development of global standards for all the MNC's constituent entities worldwide. European companies have historically been considered as polycentric (Miroshnik & Basu 2014:3; Malnight 1996:46; Perlmutter 1969:13), reflected in their preference for a decentralized country-centered strategy of control, as seen in a majority of UK companies. American MNCs, contrastingly, have traditionally given preference to the ethnocentric model (Miroshnik & Basu 2014:3; Malnight 1996:46). Recent international business literature indicates a change away from both centralized and decentralized organizational models for MNCs towards a network-based approach (Miroshnik & Basu 2014:3), which is also being applied for control systems of MNCs (Betts, Laud, Mir & Vicari 2012:5).

Perlmutter's (1969) classification of the above-mentioned concepts of "centrisms" was derived primarily from the attitudes of management on headquarters' orientation towards subsidiaries of a MNC (Hedlund 1986). Table 1 presents the organisational attributes considered.

Nearly two decades later Hedlund (1986) expanded on Perlmutter's original concept. He identified the concept of a "heterarchical MNC" as a geocentric organization (Hedlund 1986:20). The heterarchical MNC differs from the abovementioned geocentric MNC in terms of its strategy and structure. The strategy of a heterarchical MNC is embedded in the notion of actively exploiting the advantages of multinationality (Hedlund 1986:20). Its structure is conducive to the achievement of both global integration and local differentiation (Hedlund 1986:21). This could mean that a heterarchical MNC has many centres and these centres differ in nature. Subsidiary managers are also given a strategic role within the MNC as a whole, more freedom and flexibility is provided to organizational units, while integration is achieved through normative control (for example the corporate culture becomes critical)

(Hedlund 1986:20-24). Hedlund (1986:24) sees a heterarchy as an organization “where information

about the whole is contained in each part”.

**Table 1: Organizational attitudes used by Perlmutter**

Attributes of the organization	Ethnocentric	Polycentric	Geocentric
Complexity	Complex in home country, simple in subsidiaries	Varied and independent	Complex and interdependent
Authority and decision-making	High in headquarters	Relatively low in headquarters	Collaborative approach between headquarters and subsidiaries
Evaluation and control	Home standards apply	Determined locally	Standards that are internationally accepted – also locally relevant
Rewards, punishments and incentives	High in head office, low in subsidiaries	Varies	International and local executives rewarded for reaching local and worldwide objectives
Communication and information flow	High volume to subsidiary offices – orders, commands and advice	Little to and from headquarter. Little between subsidiaries	Across subsidiary offices and headquarter. Heads of subsidiaries part of management team
Identification	Nationality of the owner	Nationality of the host country	International organization considering national interests
Recruiting, staffing and development	Recruit and develop individuals from home country for key positions elsewhere in the world	Develop individuals of local nationality for key positions in their own country	Focus on the most suitable individuals, regardless of country of origin – development for key positions everywhere in the world

Source: Perlmutter (1969)

Using Perlmutter’s geocentric model (1969) as a departure point, later studies have attempted to construct typologies of MNCs, and the variables used can be summarized under the following broad headings: environment; strategy; structure, and systems and processes, the last of which includes control mechanisms and human resource management (Harzing 2000). In the review of theoretical approaches for MNCs, Pesalj (2011) maintains that a MNC is a differentiated inter-organizational network, which consists of a system of interrelated and interconnected organizational parts.

From the above it is clear that Perlmutter’s geocentric model supporting a global mindset (Levy, Beechler, Taylor & Boyacigiller 2007:232) has spawned a stream of research showing the multidimensional heterarchical intra- and interfirm relationships forged by MNCs, rather than the vertical unilateral hierarchical relationships between headquarters and foreign subsidiaries that epitomizes an ethnocentric model (Tolentino 2002). MNCs benefit from the generation and transfer of resources and competencies from and between their foreign subsidiaries located in different parts of the world (Tolentino 2002).

Practices of external auditors, who seem to be facing the same challenges as internal auditors in relation to geographically dispersed work, mirror a geocentric approach. Audit arrangements across geographical boundaries are becoming prevalent in the operating styles of big audit firms (Hanes 2013:2). These assignments involve multiple locations and the effective coordination of work becomes a crucial factor for success (Hanes 2013; PwC 2013:11; Hegazy & Nahass 2012; Barrett, Cooper & Jamal 2005). Multinational audits cannot be treated as imitations of existing domestic processes (Hanes

2013:2); auditing MNCs challenges audit firms to find the right balance between localization and globalization for their operations (Barett *et al* 2005; Cooper, Greenwood, Hinings & Brown 1998), epitomizing the geocentric approach, as described above.

As contemporary companies expand their foreign operations, the physical presence of internal auditors abroad has become a necessity (Stippich 2011; Murdock 2006). Although the traditional organisational structure of internal controls requires the adoption of a centralized model, the existing environment and the identified coercive, mimetic and normative pressures drive MNCs’ internal auditing practices towards geocentricity, carrying with it a certain degree of autonomy for local internal audit units, while simultaneously requiring a global standardisation of approaches and standards that ensure enterprise-wide consistency of internal audits. Based on the review of international business management concepts it appears that internal auditing in MNCs should be approached from a geocentric perspective, with collaboration between geographically dispersed locations being promoted. The following section presents factors that should be considered when following a geocentric approach to structuring the internal audit function in a MNC.

**6 FACTORS TO CONSIDER WHEN APPLYING A GEOCENTRIC APPROACH**

MNCs are not homogenous. Thus, the structure of their internal audit functions, as with any other aspect of the enterprise, is determined by a variety of factors. These include the size, volume and diversity of operations; the nature of internal controls; the characteristics of the portfolio of risks; the overall

objectives of internal audit, and the available resources (IIARF 2010; Moeller 2009:283). The geographical distribution of a MNC's activities adds a further dimension, challenging organisations to find a way to ensure consistent and adequate audit coverage of the entity's entire suite of operation (Moeller 2009:283; Chan 1995:44). Following a geocentric approach therefore, require internal audit functions to consider the need for customization of internal audit processes to accommodate the unique requirements of foreign locations, and to embed mechanisms that ultimately provide for enterprise-wide homogenization and the convergence of all its internal audit services.

### 6.1 Localization of internal auditing

The IIA seeks to achieve the harmonization of internal auditing practices around the world through its International Standards for the Professional Practice of Internal Auditing (Standards), and their other professional practice guidance (Vanasco *et al* 1995: 40). This follows directly from the stated mission of the IIA, and was reiterated by Richard Chambers (a past president and CEO of the IIA), when he stated: "the profession is poised to continue the realignment that has been going on for a couple of years" (Whitehouse 2011:6). Sarens and Abdolmohammadi (2011), in their empirical research found strong evidence of a high degree of convergence between internal auditing practices in different countries. But despite the acknowledged trend towards global uniformity of internal audit approaches, numerous comparative studies of internal audit practices have revealed substantial variations, both within regions and between countries, in the perceived roles and responsibilities of internal audit functions, and the way internal audit is performed (see, for example, the Common Body of Knowledge Research, conducted by IIARF (2014) which investigated internal auditing practices around the world; Paape, Scheffe and Snoep (2003) whose research focused on European Union countries; and Selim, Woodward and Allegrini (2009) who compared the internal auditing practices in the UK, Ireland and Italy).

Burnaby *et al* (2009:6) claim that the local context determines the way internal auditing is performed. This view is shared by Sarens and Abdolmohammadi (2011), who believe that the achievement of global convergence of internal auditing practices is inhibited by contextual variables. The diversity of internal auditing practices between (and within) countries substantiates the need for a sound understanding of contextual variables so as to achieve effective management of internal audit units in foreign locations.

Despite an exhaustive search, the authors have not become aware of any academic research in the field of internal auditing that provides a specific theoretical basis from which to examine the local contextual variations that might impact the internal auditing

activity across national boundaries. In contrast, international business literature offers a myriad of theoretical and empirically tested frameworks aimed at identifying and assessing contextual variables, an understanding of which is necessary to effect a sound understanding of and embedding in a foreign local environment (Kimiagari, Keivanpour, Mohiddin & Van Horne 2013; Meyer, Mudambi & Narula 2011; Muritiba, Muritiba, Galvao de Albuquerque, Bertoia & French 2010; Vrontis, Thrassou & Lamprinou 2008; Tong & Reuer 2007). Meyer *et al* (2011:237) suggests two dimensions of local context variations: institutional frameworks and resource endowments. The applicability of these to internal audit will be discussed next.

#### 6.1.1 Institutional frameworks

As companies have increasingly "gone global", and in the process been forced to face substantial differences in local work environments, authors of international business management literature brought the term "psychic distance" into mainstream discussions. Psychic distance addresses the differences in formal and informal institutions between countries, which have to be considered while setting up operations in foreign locations (Meyer *et al* 2011:240; Hakanson & Ambos 2010:195; Muritiba *et al* 2010:26; Hosseini 2008:947). Although the investigation of institutional differences in a variety of work environments has received substantial attention from business management researchers (Meyer *et al* 2011:240; Hakanson & Ambos 2010:195; Muritiba *et al* 2010: 26), there is as yet no standard definition of psychic distance. Muritiba *et al* (2010:27) identified the components of psychic distance as follows: *cultural distance*, including language, religion, and culture, which determines business practices; *administrative distance*, including the political system, legislative framework and educational background, and *economic distance*, which includes the state of industrial development of the "other" country. A review of relatively recent studies that have compared internal auditing practices in different countries indicates that all the abovementioned components of psychic distance affect internal audit activities (see Table 2).

As the aforementioned studies highlight, the components of psychic distance are believed to explain the identified differences in internal auditing practices around the world. One can therefore conclude that the existence of substantial variations in audit practices in different locations reflects responses to local economic, social, and political environments (Burnaby *et al* 2009:5) and that this might inhibit the replication of headquarters' internal audit approaches across other locations, and thus underscores the need to align internal auditing practices with their local context. It also represents the first factor that should be considered when determining the appropriateness of a geocentric approach for multinational auditing.

Table 2: Recent publications that highlight national differences in internal audit practices

Publication/Research title	The area of research	Identified components of psychic distance, which explain the differences in internal auditing practices		
		Cultural distance	Administrative distance	Economic distance
Internal audit around the world: a perspective on global regions. The Global Internal Audit Common Body of Knowledge (IIARF 2014)	The continuing development of the internal auditing profession around the world	X	X	X
Internal auditing in the Americas (Burnaby & Hass 2011)	Investigation into the demographics of internal auditors, their organizations' compliance with the IIA Standards, and their required skills and competencies in USA, Canada and Latin American countries	X	X	X
The relationship between the internal audit function and corporate governance in the EU – a Survey (Paape <i>et al</i> 2003)	The relationship between the internal audit function and corporate governance amongst the top listed companies in the European Union		X	
Internal auditing and consulting practice: a comparison between the UK/Ireland and Italy (Selim <i>et al</i> 2009)	Comparison of internal auditing and consulting practices performed by the IIA members in the UK, Ireland and Italy	X	X	X
Global internal audit and the changing public reports by management and the auditors of publicly held corporations: a comparative study of selected automakers in the United States, Russia and Japan (Pineno & Sigurdson 2009)	Comparison of internal auditing practices and internal control assessments in US, Russian and Japanese manufacturing companies	X	X	X
Internal auditors' perception about their role in risk management. A comparison between US and Belgian companies (Sarens & De Beelde 2006)	Comparison of the perceived roles of internal auditors in risk management between Belgian and US companies, located in Belgium	X	X	X

### 6.1.2 Resource endowments

The diversity of resource endowments (geophysical through intellectual) across locations is acknowledged in the international business literature to have played a crucial role in the global expansion of business (Meyer *et al* 2011:239). Applying this concept when considering a geocentric approach for multinational auditing, it is the skills and competences of the local internal auditing unit that represents the resource endowment dimension of local contexts' variations. In other words, the feasibility of making decisions at the local level would dictate the advisability and viability of establishing internal audit units in foreign locations.

The business research literature identifies the following benefits as accruing to local autonomy (Betts *et al* 2012; Williams & Van Triest 2009; Young & Tavares 2004; Begley & Boyd 2003; Taggart & Hood 1999; Perlmutter 1969):

- improved decision-making process due to better understanding of the local environment;
- local knowledge creation, derived from innovative potential of foreign locations, and facilitated knowledge transfer; and
- enhanced organizational communication.

By applying a geocentric approach, a MNC's internal audit function is likely to encounter the same outcomes, as the internal auditing literature supports

the need for resource endowments. Local internal audit units would ensure a better understanding of the local environment, including legal and regulatory frameworks, business customs and practices (Stippich & Blackwell 2012:67; Murdock 2006:25; Sears 1994: 29). Local knowledge creation could result in a deep understanding of the operation and its related risks. This is a notion which is widely acknowledged in internal auditing literature, that business acumen and associated skills are indispensably fundamental amongst the wide range of "required" and "nice to have" internal audit capabilities (IIARF 2014:90; IIA 2013:17; PwC 2012:37).

Investigating multinational (external) audit firms, Barrett *et al* (2005:21) emphasize that local offices make a significant contribution to the success of their global businesses by virtue of their locally created innovative approaches. By similarly aligning global internal audit practices with the innovative approaches developed and adopted locally, this may result in more widely appropriate internal audit approaches (Moeller 2009:284). That internal auditors create and disseminate innovations within their internal auditing processes is widely accepted. In addition, internal auditors are also believed to contribute to the competitiveness of the whole organisation through internal benchmarking that makes use of best practices identified across the entity's different locations, and by promoting their implementation throughout the MNC (Hyland & Beckett 2002).

Physical proximity to foreign stakeholders and enhanced communication with them should enable the alignment of internal auditing's role and responsibilities across geographically dispersed and diverse locations. Meanwhile, the need for quality communication with MNCs' stakeholders was suggested by Baaij, Mom, Van den Bosch and Volberda (2012) to be the main driver for moving functional divisions (including the internal audit function) abroad.

Against this background, it appears that considering the need to align internal audit practices with the local context, and the impact of internal audit on local resource endowments (and *vice versa*) holds benefits for a MNC. A geocentric approach, allowing autonomy to local internal audit units, could thus represent a value-enhancing approach for a MNC.

## 6.2 Global alignment

If internal auditing is represented outside the home location, it is essential that consistency of internal audit approaches and performance is maintained. Cicekli (2011) identifies three general management control mechanisms routinely applied by MNCs to ensure enterprise-wide convergence of objectives, values and behaviors: *centralization*, *formalization* and *socialization*. These could be equally beneficially adopted by MNCs' internal auditing functions.

As previously discussed, the practice of centralized decision-making is widely practiced by internal audit functions of MNCs. But *centralization* holds various disadvantages, as is widely acknowledged in the management literature: it may overload headquarters' decision-making capacity, adversely affect motivation and responsiveness at the division and subsidiary levels (Betts *et al* 2012:2; Cicekli 2011:177). Internal auditing researchers concur by emphasizing the benefits of allowing some local autonomy in decision-making processes (Moeller 2009:284; Barrett *et al* 2005:11; Liu *et al* 1997:470).

MNCs need to harmonize internal audit methodologies across all divisions and locations to secure coherent internal audit performance (Chan 1995:44). Common policies and procedures, toolkits, documentation and reporting standards represent the means of achieving *formalization*. Development of uniform internal audit procedures has numerous benefits, but may not be possible in all locations due to cultural disparities, unique regulatory requirements, and even different perspectives on what comprises the "necessary" implementation of the standardized policies and procedures (Barrett *et al* 2005:10; Chan 1995:44). Only 38 percent of respondents in an international internal audit survey conducted in 2010 indicated that internal audit was equally effective in all their enterprises' locations (Ernst & Young/Forbes Insight 2010:2), which illustrates the effect diversity of local environment has on the performance of an internal audit function. However, empirical studies also show that convergence could still be achieved through the development of common internal audit frameworks (Sarens & Abdolmohammadi 2011; Barrett *et al* 2005; Chan 1995).

Acceptance and implementation of global standards is subject to effective communication of corporate objectives, values and behavioral patterns, which collectively constitute *socialization*. Business management literature provides an extensive list of mechanisms that can be used to ensure integration of strategy, goals and values, such as rotation, joint teamwork, and training programs amongst other activities, that promote informal interactions between dispersed locations (Miroshnik & Basu 2014:8; Cicekli 2011:177; Goodall & Roberts 2003:163; Milliman, Taylor & Czaplewski 2002:40). These techniques have already received the attention of internal audit professionals (Chambers & McDonald 2013; Protiviti 2012). Multinational organisations are already implementing rotation within internal audit departments (PwC 2012: 32; Baker 2010:1). Joint audits, where the audit team comprises internal auditors drawn from the MNC's different locations, provides a good opportunity to share knowledge and experience, as well as to develop team spirit and a better understanding of the organisation (Protiviti 2013). The MNC's intranet, which represents a platform for professional discussions among internal auditors from dispersed locations and is an effective tool of communication with internal audit's stakeholders, has also proved to be a viable option for alignment of values (Correia & De Faria 2004; Lee Kam Chung 2003).

Employment of various socialization mechanisms provides for effective two-way communication. The employment of common internal auditing policies and procedures throughout a MNC, if able to accommodate local nuances and experiences, can create valuable knowledge that is then incorporated into that MNC's global internal auditing standards. Integration and transfer of resources and competencies between geographically dispersed internal audit units epitomizes multidimensional heterarchical relationships that are typical of the geocentric approach.

## 7 CONCLUSION

It appears that ever-increasing global economic integration, along with the proliferation of MNCs, is creating opportunities for and driving the expansion of internal auditing functions into foreign locations. Internal auditing has to cross the borders out of the home country in order to cater for the evolving needs of its globally dispersed stakeholders, who require objective evaluations and opinions with regard to the diversified international activities of a MNC.

Internal auditing's development seems to resemble the evolution of MNCs, and to be encountering the same challenges, essentially stemming from the geographical dispersion of operations. In other words, internal audit needs to customize its methods to accommodate and address the diversity of local contexts it encounters, and to ensure its performance remains consistent and efficient. The parallels between MNCs' development and that of internal audit make theoretical frameworks and concepts, developed within the international business management research environment, equally applicable to the internal auditing functions of MNCs. Researchers have integrated agency theory, communication theory



and institutional theory, and considered coercive, mimetic and normative pressures in their development of theoretical frameworks for the globalisation of internal auditing (Endaya & Hanefah 2013; Mihret *et al* 2010; Arena & Azzone 2007; Arena *et al* 2006; Al-Twajiry *et al* 2003).

Analysis of modern internal auditing trends indicates that there is a high level of complexity in internal audit environments, which originates from the psychic distance between different countries (where psychic distance is seen as the combination of cultural, administrative and economic distances between head office and those of the subsidiaries). The need for internal audit practices to be aligned with their local contexts, and the local knowledge that is frequently created as a result, constitutes a resource endowment for internal auditing functions that could be viewed as another way to add value to the global business. Geographical dispersion and the diversity of local contexts dictates the employment of mechanisms that ensure the enterprise-wide consistency of internal audit performance and the convergence of the objectives, values and behaviors of the MNC's internal auditing functions. The practice of centralized decision-making, formalization of processes and procedures, as well as their alignment with corporate objectives, values and behaviors through various means of socialization, seem to have already been adopted by MNCs' internal auditing functions. Given this background, a geocentric approach, which implies careful customization to recognise local context within established uniform standards, seems to be an appropriate framework for the internal audit function of a MNC.

This study aimed to address the gap in the academic literature on internal auditing in MNCs, and calls for

further discussion and empirical examination of the phenomenon in the future. A literature review approach was followed, and based on previous studies in the field of international business management, a geocentric approach was identified as an appropriate structure for the internal audit function in a MNC. This implies the need for collaborative efforts on the part of the MNC's internal audit function to achieve global alignment of its internal audit practices through the development of uniform standards, determined by institutional business frameworks and the diverse resource endowments in different locations. Internal audit functions of MNCs are continually challenged to find the balance between global consistency and local responsiveness, a situation that is rich in new research directions. Future research could therefore identify influential variables and evaluate their impact on the level of autonomy needed and achieved by MNCs' local internal audit units, examine the relationship between local internal audit units and their effectiveness within the MNC's global internal audit functions, and investigate the allocation of responsibilities and resources among geographically dispersed internal audit units. Reviewing the various organisational approaches published in the international business management literature would strengthen the insights into, and offer a more comprehensive academic perspective and understanding of the global organization and coordination of internal auditing processes. The issues of internal auditing in MNCs should be further investigated in order to provide internal audit practitioners with additional (and more specifically appropriate) guidelines to help them cope with the complexities of combining global integration and local differentiation into a single internal audit methodology.

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