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**Isomorphism of Internal Audit Functions
of Higher Education Institutes in Israel**

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Abstract

Based on an investigation of institutional and agency theories, one might assume that legal forces will compel organizations in a certain organizational field to establish isomorphic structures. Thus, for example, it could be assumed that in Israel, compliance with the Internal Audit Law – 1992 (IAL-1992), which was passed over 20 years ago and obliges a wide spectrum of organizations to appoint an internal auditor, suggests that organizations will establish isomorphic internal audit functions (IAFs). Interestingly, this study reveals that while the IAFs are in place in institutes of higher education, the structure of these IAFs tend rather to be less isomorphic in nature. This discrepancy is investigated through the research questions posed here, **‘What are the forms of IAFs in universities and colleges in Israel? And why are these IAFs less isomorphic?’** Using a mixed method of qualitative and quantitative analyses assists us in revealing some answers to this puzzle.

Israeli higher education institutes comply with the IAL-1992 in two major forms: in-house and outsourced IAFs. By choosing the latter, the institutes increase their command over the IAF and reduce their associated costs. Significant differences between the institutes were discovered in the annual number of audit hours allocated to audits and in the levels of reporting channels. While analyzing the statistical results and the interviews conducted for this study, institutional logics theory receives support when the commitment of senior management to internal auditing is found to be a significant variable in explaining the variance in the less isomorphic character of the IAFs. In some cases, it was found that senior management elects to minimize the number of audit hours and to lower the level of reporting channels. This might jeopardize the “added value” and effectiveness of internal auditing in those institutes.

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PREVIEW

CHAPTER ONE

Introduction

1.1. General

The late 20th century saw some of the Western world's most powerful and emulated corporations – Enron, WorldCom in the US; Maxwell in the UK; and the Trade Bank in Israel, to name a few – once paragons of success and prosperity, overnight become symbols of their, own executives' hubris, greed and irresponsibility instead (Allegrini, Melville, Paape, & Selim, 2009; Watkins, 2003). A closer look will reveal internal auditing oversight and lack of control as contributing causes to this complex situation. For years to come, scholars, practitioners and others will analyze the string of collapses and frauds that began with such companies and led to a global financial crisis unprecedented in scale, shocking – and scaring – the public. Internal auditing has increased in importance, mainly since it was internal auditing *oversight*, often the result of managers' lack of responsibility and lack of control, that caused the demise of many high-profile companies in the last two decades (Arena & Azzone, 2009; Cohen, Krishnamoorthy, & Wright, 2004; De Smet & Mention, 2011; Gramling, Maletta, Schneider, & Church, 2004; Ho & Hutchinson, 2010).

Universities and colleges, usually considered symbols of truth, reliability and integrity, aim for good governance but like any other kind of institution, also find themselves sometimes needing to fight against bad management and corruption (Heyneman, 2007; Roche, 1994; Washburn, 2008). Roche (1994) demonstrates that, similar to the situation with many talented athletes today, that “indeed, mismanagement and corruption appear to go hand by hand in modern higher

education” (p. 131). Heyneman (2007) interviewed faculty members, administrators, and students in three universities in the former USSR and concludes that in Georgia, for example, “Tbilisi State University (TSU) is struggling to rid itself of three past characteristics: corruption, inefficiency and intellectual lethargy” (Heyneman, 2007 p. 315). One Kazakh professor mentioned, “Corruption will affect our economy. If we produce a foolish agriculturalist, and he chooses a bad crop, a bad seed, the result will affect all of us. We have suffered before from famine. We can again” (Ibid., p. 314).

Furthermore, Heyneman (2004) states that “inattention to corruption in selection will place all other aspects of a nation’s economic and social ambitions at risk” (p. 640). The entire nation’s confidence and partnership with other democracies is at risk once its higher education system is infected with corruption. Although solving the problem of corruption in an education system is not significantly different from doing so in other sectors, several preventive measures can be implemented in these education systems before the problems are even created. These might include structural reforms to close cracks through which corruption can seep and a strengthening of management’s good practice procedures (Heyneman, 2004). Internal auditing is one tool that can play a significant role in assisting management to prevent and expose corruptions in higher education institutions.

The case of Georgia’s state universities and colleges can serve as a good (actually a bad) example of fraud in the academic system. In 2007, the state was involved in a financial scandal that extended from the state’s top public universities and colleges to several departments of government. The scandal originated in the discovery by state and university auditors of numerous instances of fraud linking Georgia’s purchasing card (PCard) program. The audit report, which was issued early

2008, identified 22 cases of fraud, ranging between \$20 and \$318,324 and involving dozens of employees (Jenkins, 2013).

Before proceeding with the discussion, let us first present the definition of “internal auditing” according to the Institute of Internal Auditors (IIA):

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2012).

Many researchers (Bou-Raad, 2000; Brody & Lowe, 2003; Goodwin-Stewart & Subramaniam, 2010; Goodwin, 2003; Goodwin & Yeo, 2001; López, Aurora, & Angel, 2013; Nagy & Cenker, 2002) emphasize the importance of the objectivity and independence of internal auditors, without which the “added value” to organizations would be jeopardized. In his recently published dissertation on the effectiveness of IAFs in Libya, Abu-Azza (2012) counts among other factors the importance of internal auditors’ independence and managers’ support in achieving the goal. The ultimate value of effective internal audit functions is that they can assist organizations to explore and expose illegal and wrongful activities that have the potential of devastating them if not checked in time.

More than one researcher has called for state intervention and for the establishment of internal auditing regulations (Al-Twajry, Brierley, & Gwilliam, 2003; Christopher, 2012a; Mahzan, Zulkifli, & Umor, 2012). In this context, Israel

provides a unique case study for exploring the effect of regulation on internal auditing (Brock & Richardson, 2013; Friedberg & Mizrahi, 1998). In 1992, the Internal Audit Law (IAL-1992) was passed by the Knesset (Israeli parliament). The IAL-1992 obligates all traded firms, governmental organizations, and government-supported institutes to appoint an internal auditor, in effect forcing Israeli firms and institutions to uphold internal auditing functions. Whether this intervention is sufficient will be examined later in this thesis. The major principles of the IAL-1992 appear in the table below:

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Internal Audit Law – 5752-1992
Principles

	Topic	The Law	Section
1.	Internal Audit	"In every public body there shall be an internal audit by an internal auditor." Three major terms are provided: public body, internal audit, internal auditor.	2.(a)
2.	Eligibility	Requirements from internal auditor: individual; resident of Israel; has not been convicted of an offense involving moral turpitude; academic degree/advocate/certified accountant; has acquired two years of auditing or has participated in a professional auditing course.	3. (a)
3.	Duties	The internal auditor should examine if the activities of the public body respect the laws, moral standards, economy and efficiency. In addition, he/she should check whether these activities are effective in achieving the ends set for them. Furthermore, the internal auditor should check if the decisions taken by the public body management were reached by proper procedures.	4. (a)
4.	Duties	"The internal auditor shall carry out the audit in accordance with accepted professional standards"	4. (b)
5.	Responsibility	The officer in charge of the internal auditor in a governmental office – the Minister or Director General; in the Bank of Israel – the Governor of the bank; in any other public body – Chairman of the board of directors/Director General. The internal auditor shall be held directly responsible to his officer in charge	5. (a), (c), (d), (e)
6.	Reporting	The internal auditor shall submit a written report with his/her conclusions and recommendations to the officer in charge.	6. (a), (c)
7.	Exclusiveness of activities	The internal auditor shall not discharge any function other than internal audit. The only exception can be if the internal auditor serves the officer of public or employees' complaints.	8. (a)
8.	The staff of internal auditor's office	The internal auditor can carry out his duties with the assistance of the staff of his/her office. Appointing a person to the staff shall follow the proper procedure for appointment of employees in a public body. The staff shall be instructed solely by the internal auditor.	13. (a), (b), (c)
9.	Amendment of the Council for Higher Education law	"The provisions of Sections 3, 4, 8 through 10, 12, 14 (b) and (c) and 24 (c), of the Internal Audit Law, 5752-1992, shall, mutatis mutandis, apply to the auditor of a recognized institution". The Internal Audit Law does not apply fully to higher education institutions.	19.

Table 1 - Principles of the Internal Auditing Law - 1992

In places where the regulatory systems do not require IAFs, their very existence, much less their efficacy can be hard to detect. For instance, Christopher (2012a) argues that the inconsistent way that internal auditing is conducted in Australian public universities is symptomatic of a broader problem related to the legal framework. He claims that the absence of a comprehensive regulatory internal auditing framework leads to inconsistencies in the way that IAFs performs in the universities. “This flexible compliance scenario has provided opportunities for some university internal audit functions to adapt negatively to the loopholes in the regulatory framework, creating a gap between its theoretical and practical role” (p. 539).

In principle, three major models (as appear in figure 1) are found for adopting IAFs: *in-house*, integral IAFs within the organization; *outsourced*, external “IAFs”, which provide audit activities to the organization; and *cosourced* IAFs, a combination of the two (Desai, Gerard, & Tripathy, 2007, 2011). Usually, for the outsourced model, organizations use their external auditing provider to comply with the Law’s requirements. In these cases, the external auditors perform a dual role – external auditing for the organization’s financial reports and internal auditing for its internal operations. Schneider (2008) reported that, according to IIA surveys, there is a decreasing trend of the outsource model, that is, using a third party to perform internal audit activities, dropping from 54% of firms in 2002 to 33% in 2006. Abdolmohammadi (2012), who analyzed the responses of 1091 internal auditors worldwide, found that 58.7% of the internal auditing activities that is, all or part of those activities were outsourced. Coram et al. (2008), who examine 491 firms in Australia and New Zealand, assert,

Organizations that rely solely on outsourcing for their internal audit function are less likely to detect and self-report fraud than those that undertake at least part of their internal audit function themselves. These findings suggest that internal audit adds value through improving the control and monitoring environment within organizations to detect and self-report fraud. These results also suggest that keeping the internal audit function within the organization is more effective than completely outsourcing that function. (p. 543)

On the other end, Di Gabriele and Ojo (2013) support the duality role of the external auditors (outsourced model - external and internal auditing). This variety of opinions points to the need for deeper investigation. This study will take steps toward such investigation by examining the ways that Israeli institutes establish internal auditing functions. More specifically, it focuses on internal audit functions (IAFs),¹ their model, and the factors that influence their establishment in Israeli academic institutes.

¹ For our purposes, IAF is an organizational unit within an organization that contains at least one internal auditor and performs internal audits routinely. The head of the IAF, usually the Chief Audit Executive (CAE), reports to a certain management level in the organization about the audit's findings and conclusions (this process is referred to as "reporting channels").

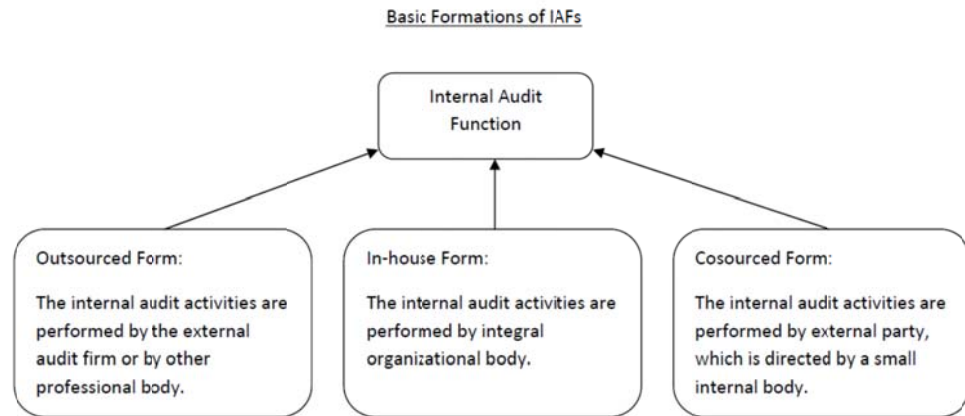


Figure 1 - Basic Formations of IAFs

So far, no coherent theory for internal auditing has been established (Paape, 2007; Swinkels, 2012). In his dissertation, Swinkels (2012) tries to establish the foundations for such a theory, though he admits that these are only first steps and a long way is anticipated before internal auditing will become a coherent theory. The absence of a coherent internal auditing theory encourages researchers to draw on other organizational theories to explain the emergence of IAFs. Using **institutional theory** as a basis for discussion, can explain the emergence of internal audit functions. Institutional forces play a major role in forming the internal auditing unit in organizations (Al-Twaijry et al., 2003; Arena, Arnaboldi, & Azzone, 2006; Arena & Azzone, 2007). In Israel, the existence of explicit internal auditing regulations forces organizations to appoint an internal auditor. These coercive forces might press organizations in a certain field to generate isomorphic IAFs. Interestingly, isomorphism is not guaranteed even when coercive pressure exists. The focal point of

this dissertation is to investigate the less isomorphic discrepancy of the IAFs in universities and colleges.

Agency theory explains the existence of internal auditor as a third party between principals and agents (Adams, 1994; Carcello, Hermanson, & Raghunandan, 2005a; Paape, 2007). Both theories - institutional and agency - explain the form of the structure of IAFs in places where they exist. Adams (1994) asked almost twenty years ago, “Why do sizes of audit units vary between organizations?” (p. 9). This question has not received adequate attention, particularly regarding the similarity and heterogeneous organizational responses to institutional forces (Greenwood, Oliver, Sahlin-Andersson, & Suddaby, 2008). Even when IAFs exist in a certain field, Adams’ question is still relevant and, in fact, it can lead us to the questions at the heart of this study, **“What are the forms of internal auditing functions?”** and **“Why are internal audit functions not isomorphic?”**

An agency theory-based model was examined as a predictor of the size of IAF in Belgian firms (Sarens, 2007a). Sarens concluded, “Internal auditing can be considered as a basic monitoring mechanism to reduce information asymmetry resulting from separation of ownership and control” (p. 18). In addition, he found a positive correlation between the size of the firm and its reporting levels (number of reporting levels between top- and lowest-level management) and the size of the IAF, i.e., larger and more complex firms will have larger IAFs. However, contrary to his

own hypothesis, Sarens finds a negative relationship between the leverage² and the size of the IAF and assumes that higher leverage will lead to higher economy of scale.

There is a strong correlation between size of the IAF and the ability to perform an effective audit plan. Additionally, reporting channels leading to the highest levels in the organizations are crucial components in internal auditors' independence (Christopher, Sarens, & Leung, 2009; Goodwin-Stewart & Kent, 2006b; Goodwin & Kent, 2004a; Montondon & Meixner, 1993; Montondon & Fischer, 1999; Paape, 2007; Paape, Scheffe, & Snoep, 2003; Sarens & Abdolmohammadi, 2011b; Sarens, Allegrini, D'Onza, & Melville, 2011a). Therefore, this study views the size of the IAF and its reporting channels as dependent variables to isomorphic IAFs (Anderson, Christ, Johnstone, & Rittenberg, 2012; Christopher et al., 2009; Gronewold & Heerlein, 2009). My claim is that two IAFs are isomorphic once they are of equivalent size (as measured by their professional staff capacity or other way of measuring size of IAF) and maintain the same reporting channels in the organizations. In the academic organizational field, although few universities and colleges are the same size, I have found that, curiously, IAFs are not isomorphic. This is a puzzle that I would like to solve.

In parallel to the corporate world, the demand for accountability in academic institutes (that is, institutes of higher education) has also increased dramatically during the last decades (Chamberlain, Gordon, & Plunkett, 1993; Christopher, 2012d;

² The leverage of the firm was measured by the proportion of total debt compared to the total assets of the firm (Sarens, 2007a).

Fischer & Montondon, 2005; Holmes & Brown, 2000; Zakaria, Susela Devi, & Zakaria, 2006). In this work, I have decided to focus on one *organizational field* as was defined by DiMaggio and Powell (1983) “By organizational field, we mean those organizations that, in the aggregate, constitute recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services and products” (p. 148). Academic institutes are highly respected in Israeli society and the way they implement the law can influence non-academic and other organizations. Public academic institutions are supported and supervised by the Council for Higher Education (CHE), while private ones do not receive CHE support but comply with its regulations. Presently, Israel has 29 public academic institutions (9 universities and 20 colleges) and 15 private colleges.

Christopher (2012b), who examined nine international universities in Australia, UK, Belgium, Netherlands, and Malaysia, found that two major forces that influence the governance of these universities are government intervention and internal management. Here we test the Israeli case, examining the compliance of Israeli universities to governmental intervention (i.e. IAL-1992) and the perceptions of top management in Israeli universities to internal auditing. Internal auditing in higher education in Malaysia serves as a good reference to the Israeli case, as the two countries share similar regulations. There, Zakaria et al. (2006) found that a substantial number of private institutions of higher education do not have an internal auditing function (their findings are described in the succeeding chapters).

Carcello et al. (2005b) depict the connections between the IAF and an organization’s characteristics and encourage additional study on the structure of IAFs