

Risk Management—How Important in Internal Control Process?

Risk Management and Other Internal Control Components in the SME Sector: Qualitative Analysis

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Abstract: Internal control, according to the COSO Internal Control—Integrated Framework (1992, 2013) consists of five components: financial control activities, risk management, internal environment, information and communication and monitoring. The main focus in internal control issues in the last time concentrate on risk management, but the practice shows that the organizations, especially SME's focused on other internal control issues. Within small and medium-sized enterprise practice in the Netherlands, internal control components are viewed differently by practising accountants than by researchers involved with these subjects and the related research:

- researchers attach far more importance to the role of risk management in the control process,
- in the opinion of practising accountants—there are other aspects play a more important role: the financing control activities and the culture (as part of control environment) within the organisation, in particular small and medium-sized enterprise practice.

This paper contains an exploratory study, consisting of qualitative in-depth interviews with nine researchers and nine accountants. The study is based on a qualitative matrix method and a visual assessment of the inter-rater reliability (the degree of agreement among raters) concerning the thematic definition of the term Internal Control.

Key words: risk management; internal control; financial control activities; COSO 1992/2013

JEL code: M400

1. Relevance to Practice

This study provides knowledge of and an insight in the opinions concerning the vision of researchers and practising accountants on Risk Management component as part of Internal Control practice of an SME enterprise in the Netherlands. The study also provides information about the discrepancy in attitudes between academic practice and accountancy practice. Practising accountants needs to be critical and to deal with scientific theories. However the empirical validated theory should be instructive for practice of internal control, especially in SME sector. The discussions in the literature and development of internal control systems are going about the importance of different internal control components, and are basis for the research described in this article.

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2. Introduction

The importance of good internal control in companies has increased significantly in recent years. There are different views about the definition of Internal Control and implementation in companies. The COSO framework for internal control (1992, 2013) identifies five components of internal control: control environment, risk assessments, control activities, information and communication and monitoring. The COSO ERM (2004), after COSO ICIF (1992, 2013), focused very highly on risk management. The discussions in the literature (De Koning, 2009; Purdy, 2010; Gupta, 2008; Lindow & Race, 2002) and development of internal control systems are still going about the importance of different internal control components, and are basis for the research described in this article.

This paper investigates how the components of Internal Control according to COSO (1992, 2013) are explained and defined by accountants and researchers, in business, in particular in the practice of small and medium-sized enterprises in the Netherlands. This is an exploratory study of convergence of Internal Control issues: a qualitative analysis of in-depth interviews with practising accountants and researchers, about their definition of Internal Control.

The four components of the COSO framework (Control environment, Risk assessment, information and communication and monitoring) are based on the way in which the management directs the organisations, while according to Lindow (Lindow & Race, 2002) the managing of risks is a significant aspect for the success of the organizations.

In evaluating the internal control components of section 404(a) SOX, using the COSO 1992 framework, it is observed by management that there is no excessive use of COSO components, because there is an absence of management vision and a “risk-based” perspective in COSO 1992 (Gupta, 2008). A solid internal control structure, and in particular monthly internal financial reporting, is essential for any business, as emphasised in the article by Henry in the framework of the identification of organisation risks (Henry et al., 2010). It is possible to find clues to the importance and definition of the components of Internal Control in literature. O’Leary refers to the control environment as one of the most important components in evaluating financial control structures, in particular the aspects of the quality of management, while information and communications systems and the control procedures in the auditing process are referred to as second and third important components (O’Leary et al., 2006). The other two components (information systems and control procedures) deliver no significant results (O’Leary et al., 2006). Risk assessment as one of the components of Internal Control is also referred to by Sawalqa as the only component that makes a significant contribution to a more effective auditing programme (Sawalqa, 2012) and by Klamm, who records a positive relationship between the weak risk assessment component and a weak financial control activity, adding that if there is a weak control environment, the following components—risk assessment, financial control activities, information and communication and monitoring—are also weak (Klamm, 2009). Ionescu refers to monitoring as one of the most important components of internal control, on the basis of which the quality of internal control can be assessed, and the effect of which can influence the effectiveness of each of the components (Ionescu, 2011).

The lack of independence and financial expertise by auditing committees, according to Krishnan, represents a shortcoming in the Internal Control of the business (Krishnan, 2005, p. 69). Weak and ineffective monitoring systems are also indicators of problems in the timely identification of Internal Control shortcomings in financial reporting (Gordon & Wilford, 2012, p. 2054). Monitoring is also related to an effective Internal Control system

(Masli et al., 2010, pp. 1001-1034). The quality of internal control has an influence on the quality of accruals; in particular in businesses with a SOX 404 declaration, there is a significant downturn in abnormal total accruals (Ashaugh-Skaife, 2008, pp. 217, 244). However, no empirical research has yet been undertaken into the method of defining and the importance of internal control components according to the COSO 1992. The indications of possible discrepancies in attitude in respect of COSO 1992 caused me to undertake an explanatory study in the form of in-depth interviews. A total of eighteen in-depth interviews were held with:

- nine researchers in the field of internal control and
- nine practising accountant.

In the first section of the interview, both groups are asked for their definition of Internal Control. A follow-up question was put to the practising accountants relating to the implementation of Internal Control in the SME sector. The answers from the respondents were subsequently analysed according to pattern analysis based on the method of Groenland and Jansen (2010).

The subjects referred to were divided into theme-based groups, according to the components of the COSO model (1992). According to the COSO model definition, there are a total of five groups/themes: control environment, risk assessment, control activities, information and communication, monitoring.

The central question for the study reads:

How is the term Internal Control interpreted and defined?

This question is answered according to an exploratory study method. The themes used by the respondents in respect of the term Internal Control are then examined according to pattern analysis. The answers are broken down into the groups/themes, and the pattern analysis is reproduced in a table. A comparative study is then carried out, that allocates the answers from the respondents to the themes, according to the components referred to in the COSO model (1992).

The article first considers the term Internal Control as described in literature, before discussing the COSO model (1992). The results of the exploratory study are then reproduced. This is followed by the inter-rater reliability study of the term Internal Control. The results of the exploratory study and inter-rater reliability are then reproduced and explained in tables and figures.

3. Internal Control

Over time, a number of different definitions have been given for the term “Internal Control” within the teaching of accountancy, from Structure Studies and Administrative Organisation through to Administrative Information Provision (Hartman, 1995, p. 32; De Koning, 2004).

What actually is internal control? Is it the art of grouping figures together (“l’art de grouper les chiffres”, but then carried out correctly” (Heirness, 1909, p. 5) or can more meaningful relationships and characteristics be identified?

More than 100 years ago, there was already discussion about the definition and meaning of the theory in practice: “How should we do it in Practice? (..)—Use the same method employed by your predecessor, then you can’t go wrong!” (...) “But were our predecessors doing it right?”(Heirness, 1909, p. 5)

The Internal Control issues are going about the systematic measures as reviews, checks and balances, methods and procedures instituted by an organization to conduct its business in an orderly and efficient manner, to detect errors/fraud, to ensure accuracy and completeness of its accounting data and adherence to its policies and

plans, to safeguard its assets and resources, to produce reliable and timely financial and management information. It is also the plan of organization and all the methods and measures used by a business to monitor assets, prevent fraud, minimize errors, verify the correctness and reliability of accounting data, promote operational efficiency, and ensure that established managerial policies are followed. Internal control extends to functions beyond the accounting and financial departments.

In literature, the definition of Internal Control is explained in different ways by different authors:

- Politics, processes, tasks, behaviour patterns and other aspects of a business (Chambers, 2005, pp. 30-31);
- “all control in the company to serve the management and implementation by other employers in the company” (Van Rietschoten, 1954);
- “control” include not only the check between the norm and reality, but also all controls and regulation of the company (Starreveld, 1985);
- “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; compliance with applicable laws and regulations.” (COSO, 1992)

According to the COSO definition, internal control is made up of several different components “Internal control consists of five interrelated components: control environment, risk assessment, control activities, information and communication, monitoring” (COSO, 1992/2004).

The COSO definition is the most complete and most extensive description of internal control in the organisation. In particular the following elements of the control environment of COSO determine the quality of internal control: “the integrity, business ethics and expertise of the employees, the style of management, the way in which authorities and responsibilities are directed by the management, and the dedication and development of the personnel, the attention paid by the management to the business and the extent to which they direct the business, the so-called “tone at the top” (Puijm, 2009, p. 227).

This study is based on the COSO definition because:

- it is a worldwide standard-COSO is used worldwide as the “standard for determining whether a business is or is not ‘in control’ (...) while among the many international corporate Governance committees, consensus seems to have been reached on the use—whether or not compulsory—of the COSO standard” (Renes, 2003);
- COSO is referred to as: “the most widely used reference model for implementing integrated risk management” (Lasance, 2010, p. 31);
- the COSO component *Control environment* determines the quality of the control framework and forms the basis for all other elements of internal control (Puijm, 2009, p. 227);
- the COSO framework pays attention to ethical values in the organisation and their effect: “integrity and ethical values are essential elements of the control environment, affecting the design, administration and monitoring of other internal control components” (COSO, 1992, Evaluation tools, p. 23, see also COSO, 2013).

The next paragraph deals briefly with the development of the COSO framework over the course of time, whereby a choice was subsequently made for the structure of the theme/components of the term Internal Control.

4. COSO

In 1994, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) under the

chairmanship of James C. Treadway, introduced the first Corporate Governance framework for internal control.

The COSO committee was appointed in 1985, on the initiative of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission, after its chairman), which was tasked with investigating the causal factors of fraudulent financial reporting. The activities of the COSO committee were sponsored by various private organisations. The most important task was to further elaborate the definition Internal Control. The Committee also issued recommendations for public companies, accountants, the SEC and other supervisory bodies and for educational purposes (COSO, 1994, <http://www.coso.org/aboutus.htm>).

The first world-famous framework for internal control (COSO Report: Internal Control—An Integrated Framework, 1992) was succeeded in 2004 by COSO ERM (Enterprise Risk Management Framework, 2004). COSO 2004 had several different objectives: Enterprise Risk Management (ERM), internal control and fraud limitation. COSO ERM is a response to the demand for more information about risk management as expressed by management, a broadly-accepted ERM framework and clear instructions for organisations in improving risk management (COSO ERM, <http://www.coso.org>).

COSO 2004 was far more broadly and extensively structured than its original predecessor, COSO 1992, and recently COSO 2013. The definition of internal control was revised into a broader definition of Enterprise Risk Management, of which internal control is an integral part. The components of the broad definition of Enterprise Risk Management were topped up to eight, as compared to the original five. The new components are above all focused on Risk Management. Further development of the COSO versions (2006, 2011 Draft version, 2013) however demonstrates that the five original COSO 1994 components for internal control have been reintroduced, rather than the eight components of COSO ERM. This study examines whether the development of the COSO framework was followed in the same way by researchers and practising accountants.

5. Themes and Components of COSO 1992/2013

The study method employed involves in-depth interviews with nine researchers and nine accountants, whereby all were asked to provide a definition of the term Internal Control.

According to the answers given, a matrix table was compiled, in which the themes from the COSO framework for Internal Control are featured. The specified themes are ticked in the table, and according to the outcomes, the results and development patterns are reproduced.

In all answers given to the question “what is internal control?”, it emerges that all respondents refer to suitable measures for the business, on the basis of the information obtained. The formulation of the objective and role of the manager in a business plays an important role, in that connection. Based on the literature study, the term Internal Control can be broken down into the following themes:

5.1 Themes

(1) Statutory/legal aspects: COSO definition/COSO targets, legislation and regulations, social standards/adjustment, quality requirements (regulations, management, etc.);

(2) Risk management: risk limitation, risk avoidance, risk analysis, risk appetite, risks, threats and opportunities, CPI (Critical Performance Indicators);

(3) Information and communication: reliable financial reporting, information, information (flows/systems), communication;

(4) Targets/processes: targets (profit, growth and quality targets), process development (effective and efficient),

households, internal/external affairs;

(5) Supervisors: shareholder(ship), stakeholder, management/management control/human resource control, governance structure.

The themes in internal control referred to above are formulated on the basis of the subjects referred to in the question: “What is internal control?” (see Table 1 for examples).

Table 1 Examples Answers of Target Group Respondents by Question: What is Internal Control?

Examples answers:
“(…) internal control—for me it is simply the process, structures, information and all the things we are controlled in our organization, and internal control means—prevention of risks, not all of risks because that is impossible, but especially those risks that you can expect. And, yes, that is for me, if you can guarantee the good regulations within business processes. Structure, information, information, also, huh, also plays a major role. You can also get out of control because your information, you get, is not proper, unclear, for example, but for me it is not so detailed description as other people define internal control. “
“Internal control , it is, it is of course a complex definition, as we call it. Internal control is obviously a huge range: it is about the job description , your job process, hierarchical structure, you have in organization? These are the main aspects of internal control. Why? - internal control can ensure that all the company’s processes, such as communication, reporting, financial results, performed correctly and you are in-control, it is internal control—all about the company, the structure, the empowerment, the procedure, job description, accountability, environment.”

Based on the literature study and the results of this study, a comparison is made of the extent to which there are universal and repeatedly-recurring subjects of difference, in formulating the definition of internal control. The named themes are reproduced in the Table 2, below, with a comparison between the two groups of respondents, namely practising accountants and theoretical experts: professors/researchers.

Table 2 Themes of Internal Control Named by Researchers &by Practicing Accountants

Themes Definition Internal Control	Theme: Legal aspects	Theme: Risk management	Theme: Information and communication	Theme: Targets/processes	Theme: Supervisors
Total by researchers	##### # III	##### ##### ##### ##### II	#####	##### ##### III	##### II
Total by practising accountants.	###	### ##### ###	###-###-I	###-#####	###

Note: ###= the number of answers occurring five times

It can be concluded from the tables above that the first group of respondents (researchers) divide their attention between risk management, targets/processes, legal themes and—to a lesser extent-supervisors and information/communication.

The second group of respondents (the practising accountants), above all divided their thematic preferences between the targets/processes on the one hand and risk management on the other. Practising accountants focus less attention on the theme information and communication. Supervisors and legal aspects play practically no role whatsoever for practising accountants in defining the term Internal Control.

The various responses are reproduced in diagrammatic form on the next page (see Figure 1 and Figure 2).

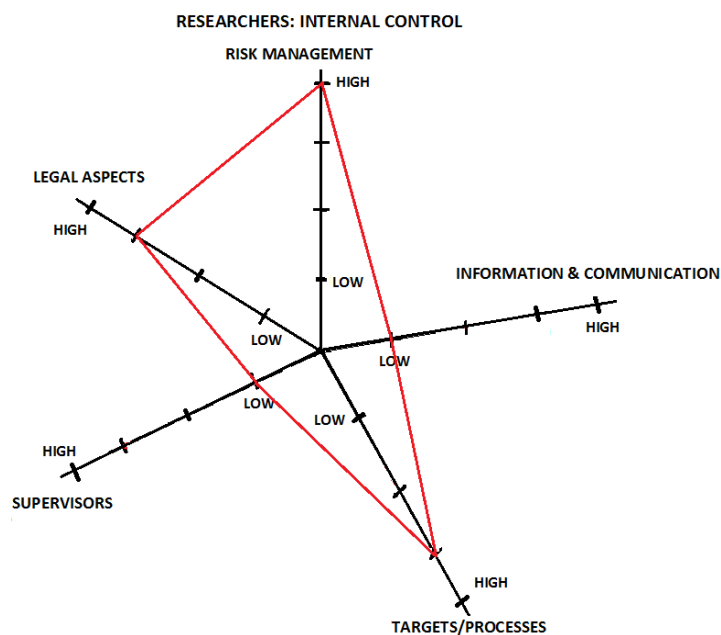


Figure 1 COSO Themes in Internal Control, Definition Door Researchers

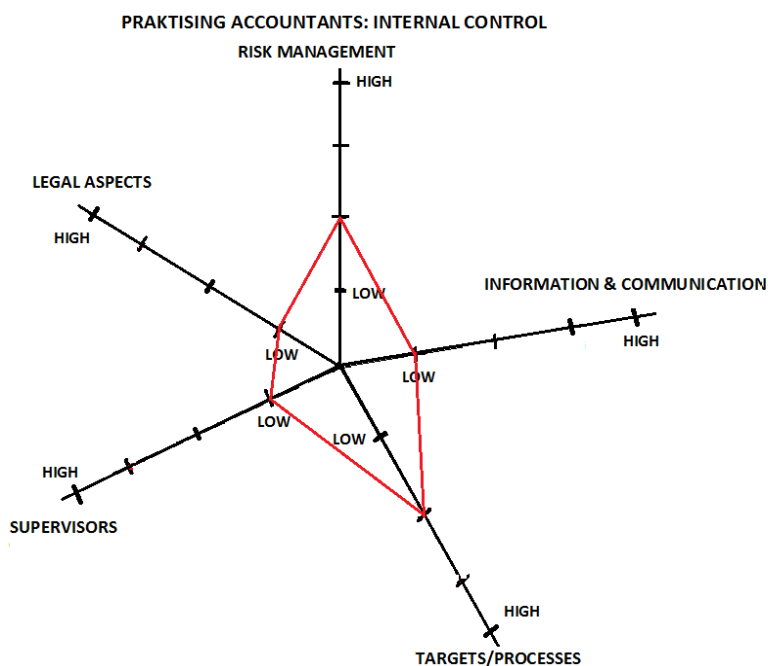


Figure 2 COSO Themes in Internal Control, Definition by Accountants

6. Comparative Study “COSO Components in the Definition of Internal Control”

Following on from the inventory of the COSO themes named in the answers from the respondents (researchers and accountants), an analysis was undertaken into the five components of the COSO model 1992.

This study employs the qualitative matrix method and a visual assessment of inter-rater reliability. Five raters from the completed study were involved, including the researcher carrying out the study himself, and four other researchers/academics. Each rater was given a summary of COSO to read (Internal Control–Integrated Framework,

Executive summary), in particular the definition and COSO components 1992: “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; compliance with applicable laws and regulations.” (COSO, 1992/2013, <http://www.coso.org>).

The five components of the COSO model are: control environment, risk assessment, control activities, information & communication and monitoring (COSO, 1992/2013, <http://www.coso.org>). Each rater was given the first 15-20 lines (approx. ½ A4) of the answers given by each interviewee. On the basis of this information, the researcher allocated scores to the themes, and marked them in an empty table by way of matrix analysis (Groenland & Jansen H., 2010).

In this study, the raters examined which of the five named components (themes 1/2/3/4/5) were mentioned in the answers from the respondents.

The five raters interpreted the following components:

(1) What is internal control? (answers from nine researchers, approx. ½ A4) (Table 3);

(2) What is internal control? (answers from nine accountants, approx. ½ A4) (Table 3);

(3) What does internal control mean in the SME sector? (answers from nine accountants, approx. ½ A4) (Table 4);

Table 3 What is Internal Control? By Researchers & Practising Accountants

Respondent	Theme 1 control environment	Theme 2 risk assessment	Theme 3 control activities	Theme 4 information communication &	Theme 5 monitoring
Total researchers by	II	IIIIIIII IIIIIIII IIIIIIII IIIIIIII III	IIIIIIIIIIIIIIIIII IIIIIIIIII	IIIIIIIIII IIIIIIIIII II	IIIIIIII I
Total by practising accountants.	IIIIIIIIIIIIIIIIII III	IIIIIIIIIIIIIIIIII I	IIIIIIIIII IIIIIIIIII IIIIIIIIII III	IIIIIIIIIIIIIIIIIIII	IIIIIIII IIII

Note: IIII = the number of answers occurring five times

Table 4 What is Internal Control in the SME Sector? By Accountants, Summary: All Raters

Respondent	Theme 1 control environment	Theme 2 risk assessment	Theme 3 control activities	Theme 4 information communication &	Theme 5 monitoring
Total	IIIIIIIIIIII IIIIIIIIIIII IIII	IIIIIIII	IIIIIIIIIIII IIIIIIIIIIII IIIIIIIIIIII	IIIIIIIIIIIIII	IIII II

Note: IIII = the number of answers occurring five times

Over the next few pages, the distribution of the answers across the various themes (COSO components) is reproduced in diagrammatic form, in three figures (Figures 3-5) on a five-dimensional scale. The terms high/average/low are used, and according to the pattern distribution in the tables above, the five dimensions are joined together by a red line. According to the figure thus generated, it is possible to see which components enjoy the highest/lowest preference among the first group (researchers). The following figures show the themes named by accountants, in respect of all businesses, and specifically for SME enterprises.

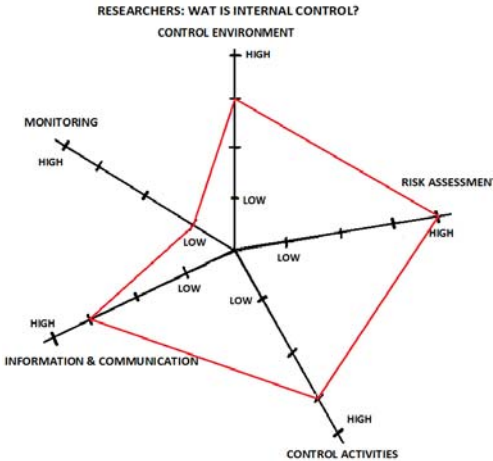


Figure 3 COSO Components (5), Relevance for Researchers

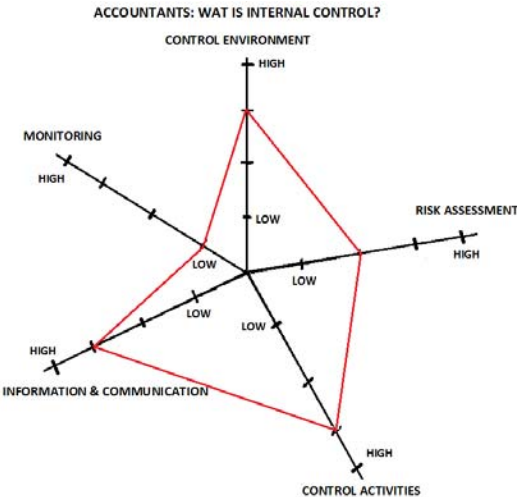


Figure 4 COSO Components (5), Relevance for Professional Practitioners

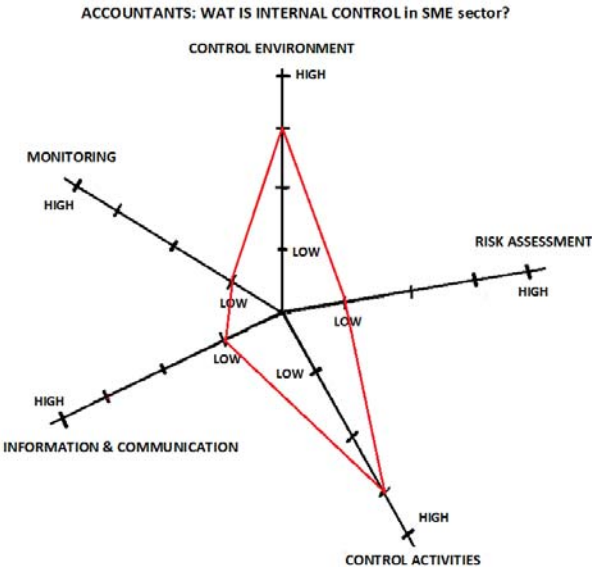


Figure 5 COSO Components (5), Relevance for Professional Practitioners

The above Figures show that monitoring scores low in all three figures (the lowest among accountants in respect of the SME sector).

This theme was subsequently removed and the named themes were reproduced in the figures below. These themes refer to the 4 components:

- control environment,
- risk assessment,
- information and communication,
- control activities,

According to these four dimensions, it is clear that the subject *risk assessment* scores highest among researchers, while in the practice of internal control, this is not the most important issue and that in respect of the SME sector, the components information/communication and risk assessment play an even less important role.

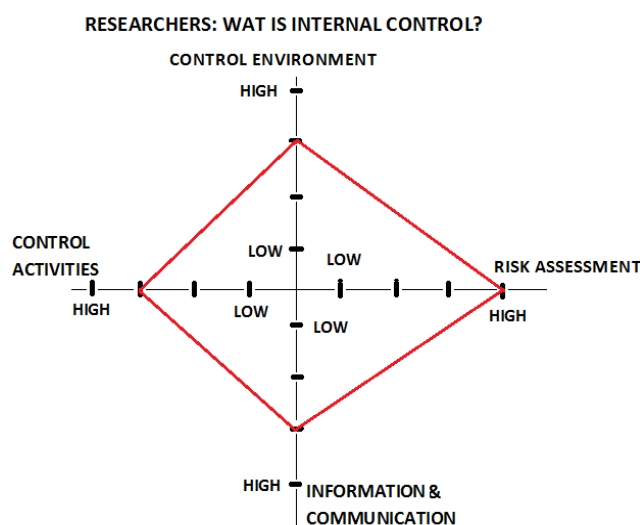


Figure 6 COSO Components (4), Relevance for Researchers

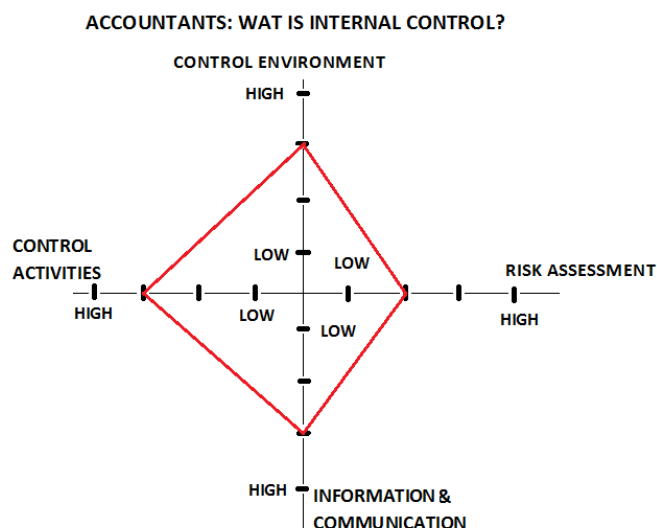


Figure 7 COSO Components (4), Relevance for Professional Practitioners

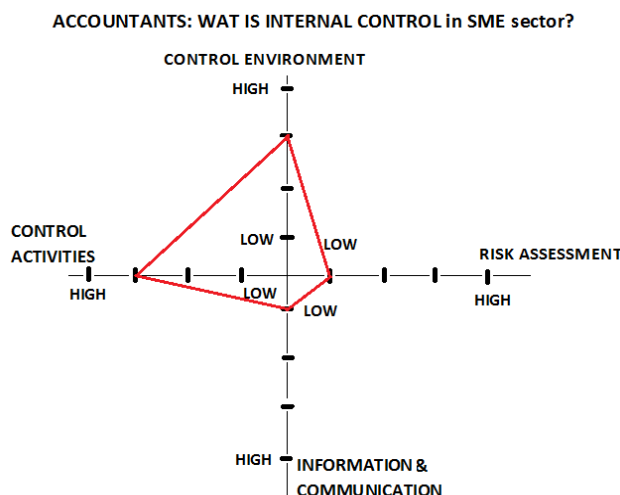


Figure 8 COSO Components (4), Relevance in SME Sector According to Professional Practitioners

7. Conclusions

The study described in this paper is an exploratory study into the definition given by researcher and practicing accountants to the term internal control.

The first point investigated was the themes named by both groups of professionals in relation to internal control. In that investigation, it emerged that risk management and targets/processes scored high among researchers. Legal aspects achieved an average score, while information/communication and supervisors scored low.

The latter two themes also scored low among accountants, as did legal requirements. Risk management and targets/processes achieved an average score among accountants. The conclusion is that researchers above all attach more value to risk management and targets/processes than practicing accountants. Legal aspects also achieved a higher score among researchers.

The second part of the described study relates to an inter-rated study, whereby five experts analyzed a description of the COSO framework and the way in which it was defined by members of two professional groups. The study revealed that the COSO component monitoring scored low among both groups of professionals.

With this component removed, there was a major discrepancy in terms of scores above all for risk management, between both groups of professionals, whereby it was noticeable that accountants above all discounted risk management and information/communication in the SME environment.

A possible general conclusion is that the spheres of interest of researchers and practicing accountants differ widely.

There could be two possible reasons for this divergence: practicing accountants are lagging behind in terms of applying modern approaches to internal control, and in particular the application of risk management.

Modern approaches and in particular risk management, are too far removed from practice to be able to be successfully applied.

The purpose of this study was not to identify which of these two explanations is most plausible.

7.1 Limits of the Study

This study was undertaken among a limited group of (9) researchers and a limited group of (9) accountants.

The selection of respondents was non-random. There is therefore some doubt concerning the representativeness of the study. Furthermore, the sample is too limited in size to be able to make (statistically-reliable) statements on the entire population.

The study is exploratory in character. The only point of investigation was whether there was a divergence in the priorities of researchers and professional practitioners. No attempt was made to explain any discrepancies in priorities.

There may be a response bias. The respondents probably wanted to make a good impression, as a result of which a discrepancy could occur between the answers given and their activities in practice or in the studies undertaken.

7.2 Suggestions for Further Study

In a further study, the possible explanations for the most notable results as formulated in “5. Conclusions” could be further assessed, in addition to which it would be interesting to continue this study on a larger scale, to make it possible to be able to draw statistically-reliable conclusions.

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