Assessment of corporate governance via internal audit

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Abstract: Technological advancements have recently sharpened the ever-increasing attention on internal auditing. Simultaneously, corporate governance has received wide attention in recent years because of the major accounting scandals and large-scale corporate failures. Unfortunately, there is no such a study for the case of Greece that examines the interaction between internal audit and corporate governance. In this concept, the main purpose of the present paper is to sketch in broad brushstrokes the relationship between internal audit and corporate governance. According to up-to-date theoretical and empirical literature, the results point out the factors that assess the interaction between internal audit and corporate governance.

Keywords: Internal auditing, Corporate governance, Auditing, Add value, Role of auditors

1. INTRODUCTION

Corporate governance has achieved growing recognition in recent years in response to financial reporting scandals such as Enron, WorldCom and Parmalat, which diminished confidence in the independence and reliability of not only the auditing firms involved, but also the accounting profession and financial markets as a whole (Ibrahim El-Sayed Ebaid, 2011). Within this framework of modern business world, the role of an internal control system is catalytic since it is regarded as a source from which core abilities are given or drawn and are subsequently transformed into competitive advantages. However, the crucial role of internal auditing for the business success, there is no such a study examining the interaction between internal auditing and corporate governance (Karagiorgos et al., 2010). For the above reasons the purpose of this paper is to examine the impact of internal auditing on corporate governance practices.

The remainder of the paper is organized as follows. The next section examines the conceptual framework of internal auditing. The third section presents the literature review analyzing the most important studies in regard with internal auditing and corporate governance. The correlation between internal auditing and corporate governance is analyzed in the fourth section. Then, the fifth section summarizes the paper, presents major findings of the study and forwards the ensuing conclusions. Finally, the paper concludes by limitations of the study and future research directions.

2. CONCEPTUAL FRAMEWORK OF INTERNAL AUDITING

Traditionally, the internal audit function was designed to safeguard firm’s assets and assist in the production of reliable accounting information for decision-making purposes (Ibrahim El-Sayed Ebaid, 2011).

Nowadays, the role of internal audit has been dramatically altered. In this concept, one of the most comprehensive definition is given by Sawyer (2003) who stated that internal auditing is “a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether (1) financial and operating information is accurate and reliable, (2) risks to the enterprise are identified and minimized, (3) external regulations and acceptable internal policies and procedures are followed, (4) satisfactory...
operating criteria are met, (5) resources are used efficiently and economically and (6) the organization ’s objectives are effectively achieved – all for the purpose of consulting with management and for assisting members of the organization in the effective discharge of their governance responsibilities”. This definition shows that the role of internal audit has been dramatically shifted from compliance assurance and assets safeguarding to value-added assurance and consulting services through its role in monitoring, evaluating, and improving risk management, control, and governance process which are critical to preserving and enhancing stakeholders value (Bou-Raad, 2000).

In conjunction with the above, the issues of corporate governance have attracted the attention of scholars on a broad scale over the last three decades, even though these issues have long existed (Okpara, 2011). Corporate governance systems are defined in a variety of contexts (Pergola and Joseph, 2011). In this respect, Hussey (1999) defines corporate governance as the manner in which organizations are managed and the nature of accountability of the managers to the owners.

Hence, the OECD (1999) defines corporate governance as “A set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”.

More recently, Roe (2004) defines corporate governance as the relationships at the top of the firm-the board of directors, the senior managers, and the stockholders. In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm. The above definition of corporate governance indicates idea of objectives correspondence, incentives, monitoring and control (Staciokas and Rupsys, 2005).

3. LITERATURE REVIEW
The much publicised corporate collapses of the past few years have focused global attention on the need for strong corporate governance. Simultaneously, the Sarbanes-Oxley Act of 2002 and the new expanded role of internal audit preoccupied researchers and scientists.

Paape et al. (2003), explores the relationship between internal audit and corporate governance. The survey data are collected from the largest companies of 15 European Union countries. To accomplish the survey 332 questionnaires were sent, of which one hundred and five were answered (response rate 32%). The basic result of this research is the differences during internal auditors work and the perception of the role of internal auditors to corporate governance by country. Hence, it is a fact that there is lack of internal audit and audit committee on 50 companies and business managers are unaware of the recommendations and regulations on corporate governance. Finally, compliance with regulations and procedures viewed as the main purpose of internal audit, while the implementation of operational controls is considered as the main contributor of internal control.

Research on the relationship between audit committee and internal audit was conducted by Goodwin (2003). The survey used questionnaire, addressed to internal auditors of financial institutions (public and private sectors) from Australia and New Zealand, who were members of the Institute of Internal Auditors. More precisely, 370 questionnaires were sent and 120 responses were received, giving an overall response rate of 32%. Of the responses, it is concluded that independence and accounting experience have a complementary impact on audit committee relations with internal audit. Hence, the differences observed between the two countries and the private and public sectors are stressed.
One year later, Leung et al. (2004), investigated the role of internal audit in corporate governance in Australia. Questionnaires were sent to internal auditors and directors of Australian financial institutions. Research objectives were the identification of internal audit’s objectives, the determination of the internal control’ nature and the importance of corporate governance within the economic units. The main output from their research was the fact that the culture and the support of the Board of Directors are key factors that directly affects internal audit’s effectiveness.

In this context, Gramling et. al. (2004) explored the relationship between internal audit and corporate governance. The most important finding of this study was the catalytic role of internal auditing in the effective corporate governance.

More recently, Christopher et. al. (2010) presented a critical analysis of the independence of the internal audit function through its relationship with management and the audit committee. Results are based on a critical comparison of responses from questionnaires sent out to Australian chief audit executives (CAEs) versus existing literature and best practice guidelines. With respect to the internal audit function’s relationship with the audit committee, significant threats identified include CAEs not reporting functionally to the audit committee; the audit committee not having sole responsibility for appointing, dismissing and evaluating the CAE; and not having all audit committee members or at least one member qualified in accounting.

In the same period, Sarens and Christopher (2010) explored the association between corporate governance guidelines, risk management and internal control practices. Data for the study were collected through a questionnaire that was sent out to chief audit executives in Australia and Belgium. The paper finds that the weaker focus of the Belgian corporate governance guidelines on risk management and internal control is associated with less developed risk management and internal control systems in Belgian companies than in Australian companies.

Finally, Ibrahim ElxSayed Ebaid (2011) explore the nature and characteristics of internal audit function in Egyptian listed firms and assess its ability to fulfil its role in corporate governance. The study has been carried out through a questionnaire survey. The results showed that internal audit function in Egyptian listed firms, in its current status, faces many difficulties that affect negatively its effectiveness in corporate governance. Therefore, extensive efforts should be made to enhancing the internal audit profession in Egypt.

4. INTERNAL AUDIT AND CORPORATE GOVERNANCE

The contribution of internal auditing to corporate governance is depicted via demarcating the relationship between internal audit and key practices of corporate governance. The governance practices considered in this study include the board of directors and the audit committee.

In this concept, it is a fact that the Board of Directors has been recognised as the key player in corporate governance by regulators and governance committees around the world (US Congress, 2002; ASX, 2003). Because of the fact that the Board of Directors is ultimately responsible for the entity’s accomplishment of its objectives, the internal auditor’s contribution is to providing information to that group (Colbert, 2002). Apart from the above, internal audit’s role is crucial to assisting the Board of Directors in its governance self-assessment.

Based on the Audit Committee, on the one hand internal auditing contribute to corporate governance by: bringing best practice ideas about internal controls and risk management processes to the audit committee, providing information about any fraudulent activities or irregularities (Rezaee and Lander, 1993), conducting annual audits and reporting the results to
the audit Committee and encouraging audit committee to conduct periodic reviews of its activities and practises compared with current best practises to ensure that its activities are constituent with leading practises (Karagiorgos et al., 2010). From the other hand, an effective audit committee strengthens the position of the internal audit function by providing an independent and supportive environment and reviews the effectiveness of the internal audit function. More precisely, the audit committee should review with management and chief audit executive the plans, activities and organizational structure of the internal audit function; ensure that there are no unjustified limitations and review the effectiveness of the internal audit function (Sawyer, 2003).

5. CONCLUSIONS AND FURTHER RESEARCH

Internal auditing has evolved from an essentially accounting – oriented craft to a management – oriented profession (Karagiorgos et al., 2011). In other words, at one time internal auditing functioned as a junior sibling to the independent accounting profession, and attesting to the accuracy of financial matters was the profession’s paramount concern. Now, internal auditing has established itself as a distinctive discipline with a far broader focus. Simultaneously, corporate governance has come to the forefront of academic, regulatory and investor debate (Parker et al., 2002). Key in this debate is the role that corporate governance plays in the efficient internal audit (Abor and Adjasi, 2007).

The findings stressed that on the one hand, effective corporate governance is significant for firms in developing countries because it can lead to managerial excellence and help firms with a weak corporate governance structure to raise capital and attract foreign investors. On the other hand internal audit plays a critical role in corporate governance by providing a wide spectrum of assurance and consulting services

There are some limitations to the present study which should be borne in mind when interpreting the results. The main limitation of this study is that it only examines the theoretical relationship between internal audit and corporate governance. For this reason, there are many opportunities for further research. Studies could explore via empirical evidence the interaction between the internal audit and components of corporate governance. Finally, more work is needed to gain a better understanding of how Board of Directors and Audit Committee can complement each other in strengthening corporate governance.

6. REFERENCES


