

Internal audit and its role in assuring an effective corporate governance implementation: A theoretical analysis.

التدقيق الداخلي ودوره في تحقيق تطبيق حوكمة شركات فعالة: تحليل نظري

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Abstract: Corporate governance gained a significant interest form academics and practitioners in business environment, in the last two decades or so. The misrepresentation of companies' financial reports and performance had a sever negative consequences, not just of what it caused to investors' funds and employees layoffs but also to country's economy in general. As a result, governments and related economic authorities presented laws and mechanisms (including internal audit) that should prevent such consequences. This paper aims to analyse theoretically the role of internal audit function that support and deliver a better corporate governance. It includes also discussing the auditors function and the audit committee impact and governance over company's management.

Keywords: Corporate Governance, Audit, Internal Audit Function, Audit Committee.

(JEL) Classification: H83, G34.

ملخص: لقيت حوكمة الشركات إهتمام كبيرا من قبل الأكاديميين والفاعلين في بيئة الأعمال في العقدين الأخيرين. ما قامت به المؤسسات في مغالطة الرأي العام حول تقاريرها وأدائها المالي كان له آثار سلبية وخيمة ليس فقط على أموال المستثمرين وتسريح العمال، بل كذلك على إقتصاد البلد بشكل عام. كنتيجة لما سبق، قامت الحكومات والسلطات المرتبطة بالإقتصاد بوضع قوانين وميكانيزمات (إضافة الى التدقيق الداخلي) التي من شأنها الحد من تلك الآثار السلبية. تسعى هذه الورقة البحثية الى تحليل نظريا لدور وظيفة التدقيق الداخلي من أجل دعم وإنجاح حوكمة الشركات. كما يتضمن هذا البحث مناقشة وظيفة المدققين ولجنة التدقيق وأثرها في حوكمة إدارة المؤسسة.

الكلمات المفتاحية: حوكمة الشركات، التدقيق، وظيفة التدقيق الداخلي، لجنة التدقيق.

تصنيف (JEL): H83, G34.

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1. INTRODUCTION:

With the economic openness and market globalisation, organizations tend to promote their strategic competitiveness by diversifying and expanding its activities and products. The later strategy would be a difficult challenge for most companies without sustainable financial resources. As a result and since late twentieth century, companies started to adopt Corporate Governance as mean to attract funding and capital. One reason that pushed organizations toward applying corporate governance is that it allows them to achieve their strategic goals for current stakeholders and raise their transparency for business partners, suppliers and potential investors.

The term Corporate Governance was first appeared in 1976 in the Federal Register, the official journal of the federal government by the Securities and Exchange Commission (SEC) (*Price, 2018*). This was right after the company Penn Central filed for bankruptcy in 1970 due to publicly misrepresenting the company's financial situation at that time.

From that time forward, corporate governance kept on being developed and widely imposed on companies. Similar scandals and management failure of organizations, like Penn Central, continued appearing. The most famous cases of misleading stakeholders and board of directors, in the twenty first century, were the collapse of "Enron" and "MCI Inc." (Previously known as WorldCom) in the year 2002. This was another triggering alert for government and organizations to take precaution.

Authorities across the world took action regarding falsification of companies' financial performances. The U.S for instance past many laws, the most known of them was the federal act in 2002 known as "The Sarbanes-Oxley Act". The Act cracks down on corporate fraud. It created the Public Company Accounting Oversight Board to oversee the accounting industry. It banned company loans to executives and gave job protection to whistle-blowers. The Act strengthens the independence and financial literacy of corporate boards. It holds CEOs personally responsible for errors in accounting audits (*Amadeo, 2018*).

The Sarbanes-Oxley Act emphasised, among other key requirements, on the important impact of audit, both internal and external, on the success of corporate governance.

In order for us to reach a convenient explanation of our previous problematic, we divided our research into three parts. The first part tend to focus on the definition of internal audit and other aspects related to it. The second one summarize corporate governance. And third part discusses the contribution of internal audit to support a strong corporate governance.

1.1. Research Problematic:

The research question of this paper is to examine theoretically the impact of internal audit on delivering a good corporate governance: how could internal audit support the application of corporate governance?

2. INTERNAL AUDIT:

Before we discuss Internal Audit and its process, we should briefly set a definition of the term Audit. According to Robert K Mautz “Auditing is concerned with the verification of accounting data with determining the accuracy and reliability of accounting statement and record” (*Mautz & Sharaf, 1961, p.12*).

Another approach by Professor Jeff Clement, where he defined Audit as “a means of evaluating the effectiveness of a company’s internal control, maintaining an effective system of internal control with a view to achieving company’s business objectives, obtaining reliable financial reporting on its objectives, preventing fraud and misappropriation of its assets and minimizing its cost of capital.” (*Obialor, 2017*).

Based on previous definitions, we may say, from our prospective that Audit is the process of inspecting and examining several books of accounts by one or a group of specialists (auditors) along with a physical check of existing material and resources that confirm the enterprises’ operations.

Auditing, on the other hand, oblige all departments and units within the enterprise to stick to the rules and documents of operations during their interaction internally with themselves and externally with the outside world for instance markets, suppliers, other companies ... etc.

To reach a transparent and proper audit, enterprises nowadays, are generally depending on different types of audit, the most common ones are:

- a. Internal Audit performed by selected personnel.
- b. External Audit by a dependant firm or a private Auditor.

The main goal for companies, regarding auditing, is to verify and validate accounts to ensure all transactions are completed in a fair manner, in which there will not be a slightest chance of fraud or anything suspicious is being conducted. In some cases companies apply both internal and external audit just to prove for particular parties, such as (potential future investors, government agencies and partners), that these companies operate their business just as the law stated and based on signed agreements and contracts, especially when there is an excess of capital is available for such procedure.

As we have mentioned earlier, our focus in this paper is on the internally performed audit. Therefore, in the following section we shall go through the description of internal audit in more details.

First of all, internal audit “also referred as operational audit, is a voluntary appraisal activity undertaken by an organization to provide assurance over the effectiveness of internal controls, risk management and governance to facilitate the achievement of organizational objectives. Internal audit is performed by employees of the organization who report to the audit committee of the board of directors as opposed to external audit which is carried out by professionals independent of the organization and who report to the shareholders via audit report” (*Types of Audit Engagements, 2013*).

2.1 Internal Audit Function:

As explained before, we have noticed that Internal Audit Function (IAF) has a great deal of impact on the company’s management and on the committee which it represents.

Any company’s management is expected, from the IAF, to deliver the following:

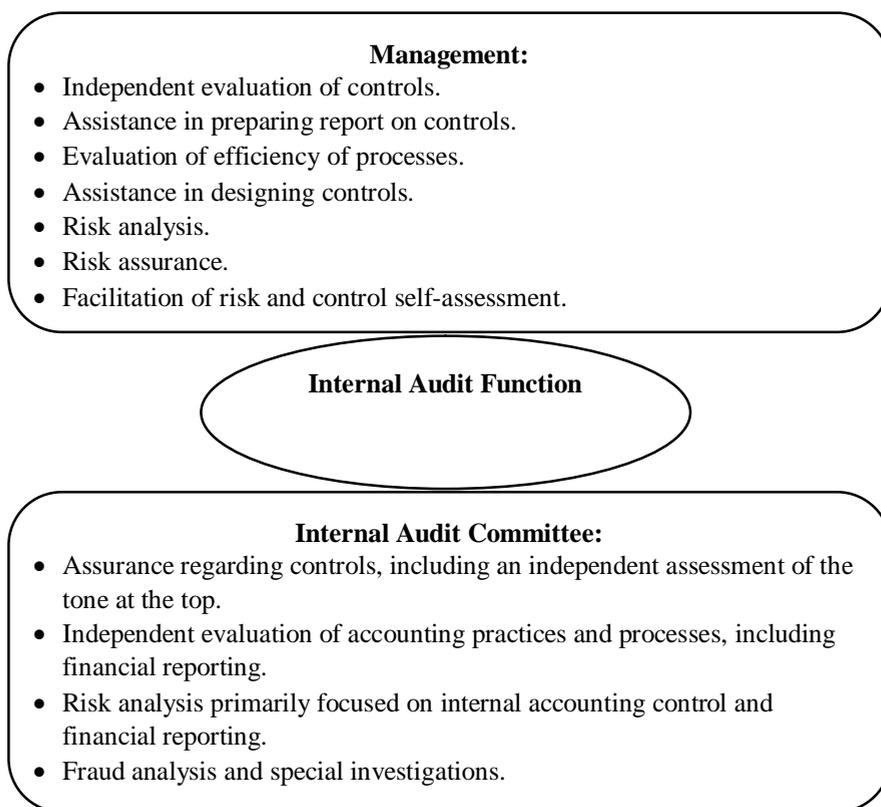
- a. An effective evaluation of current state in terms of resources, materials and performance.
- b. A solid check and verification that results transparent processes and results.
- c. Give a vital input of information to design a system of control.
- d. Monitoring the total financial performance revenues and expenditure.
- e. Risk management alerts and indices for the company’s management to monitor.

On the other hand, IAF feed the internal audit committee with important data and information in a form of reports, for example:

- a. Financial report.
- b. Accounting processes and practices.
- c. A risk analysis and fraud analysis.
- d. A field investigation that validates the reports.

The following figure (figure 1) demonstrate most of the variables involved of the Internal Audit Function in both Management and Internal Audit Committee,

Figure 01: Competing demands on Internal Audit function.



Source: (Arens et al, 2016).

3. CORPORATE GOVERNANCE:

Corporate Governance (CG) is a term in which has been used frequently in recent years. Arthur Levitt, the chairman of the U.S. SECURITIES AND EXCHANGE COMMISSION, defined CG in 1998 as “The link between a company’s management, directors, and financial reporting system” (Levitt, 1998). We can clearly note the influence of Levitt’s job background on his point of view over CG.

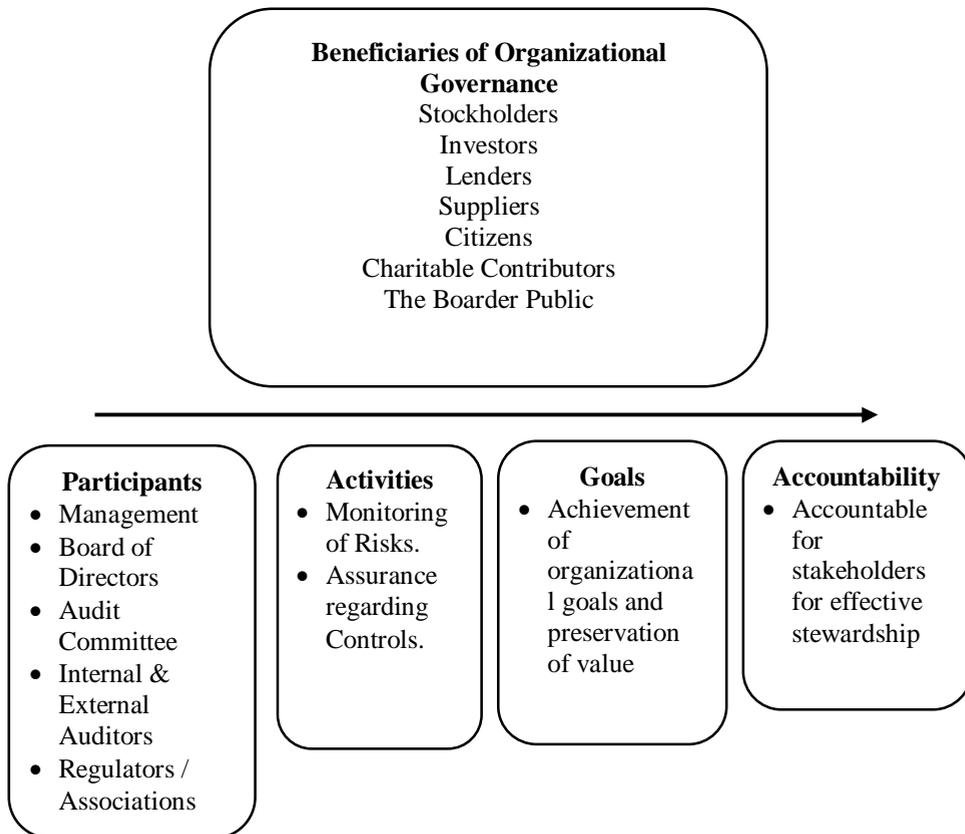
Monks and Minow, whom are considered to be the founders of GovernanceMetrics International¹, state corporate governance: “The relationship among various participants in determining the directions and performance of corporations” (*Monks & Minow, 2011, p. 20*).

We might conclude, according to the previous definitions, that corporate governance is a set of procedures and policies based on connections between multiple participants (management, board of directors, shareholders ...etc.), these procedures and policies have a direct influence on the company’s path and performance.

The Organization for Economic Co-operation and Development (OECD) gave a more complete understanding regarding corporate governance: “It involves 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...” (*Solomon, 2007, p. 19*).

The figure below illustrate the tasks of organizational governance participants in order to ameliorate and reach a suitable level of accountability and objectives for all the beneficiaries.

Figure 02: Organizational Governance

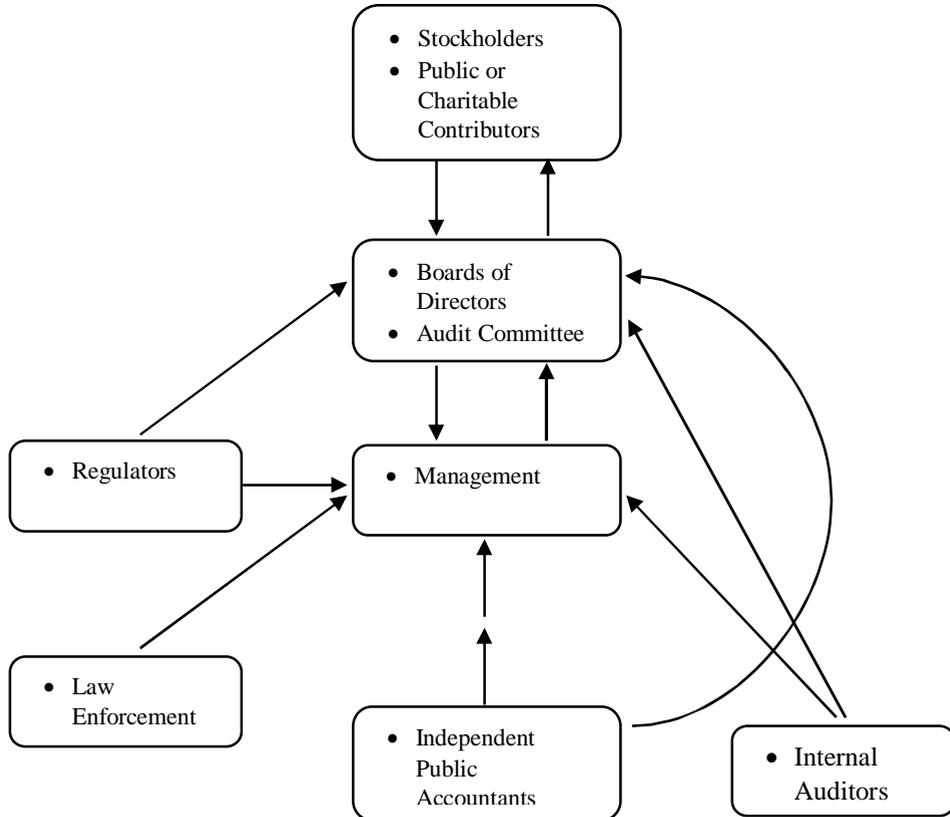


Source: (Bahrman & Foundation, 2011).

4. THE ROLE OF INTERNAL AUDIT IN IMPROVING CORPORATE GOVERNANCE:

We have seen earlier in this paper the involvement of Internal Audit, whether it applies as a committee or a function, in different key parties within a corporation (reporting, risk analysis, control and investigations ...etc.). We also presented a brief understanding of corporate governance, what it means and the participants associated with it (management, board of directors, shareholders ... etc.). In this section of the paper, we shall illustrate a theoretical connection between these two variables and how can internal audit effect, in a better way, corporate governance.

Figure 03: Involvement of Internal Auditor / Audit Committee with Corporate Governance



Source: (Hermanson & Rittenberg, 2003, p. 31).

4.1. Impact on Internal Audit Function:

Internal Audit Function perform an important role regarding corporate governance process. In past times, the only task accomplished by an internal auditor was supporting a company preserve its system on internal controls of financial reports. While in recent years, internal audit function faces a variety of responsibilities, this change was mainly due the need for organizations to reach an optimum state of assurance and governance.

4.2. Impact on Internal Auditor:

Since the internal auditor is considered by many as one of the key sources of information to the audit committee and others, his contribution has become essential for an applied governance process. The outcomes of an auditor, if done sincerely, should definitely increase the efficiency of the board of directors and management, especially when these outcomes are being revised fast and taken seriously by the audit committee.

It is an obligation for an internal auditor to make sure that the law and the company's code and rules are being applied and practiced in a correct manner, along with advising the company's management with suggestions and reporting observed issues that may become a violation in the future. Internal auditor's report make a great contribution by spotting fraud and helping managers deal with it. Therefore, internal audit will partially guarantee the correctness regarding the company' system of checks, in which it aids fraud prevention and assure an operational efficiency.

The main contribution of an internal auditor, towards a corporate governance, is the responsibilities and tasks given to him, which are mainly detecting and investigating. The effects of the latter will for sure result a sense of awareness and antifraud policies by the board of directors. Consequently, internal audit function must be supported by all corporate governance parties.

4.3. Impact on Audit Committee:

Practically all audit committee functions and responsibilities are connected directly or indirectly through corporate governance. Most proposals on legislation and stock exchange raised the key contribution of audit committee as an observation and reporting tool regarding the effectiveness of corporate governance. Furthermore, the audit committee has been an essential and important phase since it publishes reviews and recommendations, for all corporate governance parties, which contain the organization's management and financial practices after examining and analysing all its documents objectively and subjectively. Curtis Verschoor has mentioned that "The audit committee assures that proper resources are allocated to the activity and determines the breadth and scope of practices that internal auditing utilizes in the areas of risk management, control, and governance" (*Verschoor, 2008, p. 117*).

Since its first appearance, the audit committee maintains relationship with management, board of directors, stakeholders, internal and external auditors. These ongoing communications and interaction permit the audit committee to sustain its role as an indirect governing body.

4.4. Impact on Management:

We have seen before in (figure 03) the multiple connections of internal audit with other components that make a significant influence on corporate governance, management is an important one of them. Management rely regularly on internal auditors, especially when helping provide and assure:

- The operations are effective and efficient.
- The organization's processes are well controlled.
- Risks are declared and recognized when discovered in a precise way.

It is widely known that management controls the direction of a company, it sets the path by adopting a particular business strategy, in which the latter becomes a set of objectives, policies and resources divided between departments and units. In this regard, internal auditors translate the top management's objectives and policies into a guideline references for the company to follow. One of the major involvements of internal audit in company's management according to Andrew Nicolas is that "Internal audit should be employed to evaluate the management system under conditions that may have an effect on its ability to assure control" (*Nichols, 2014, p. 32*).

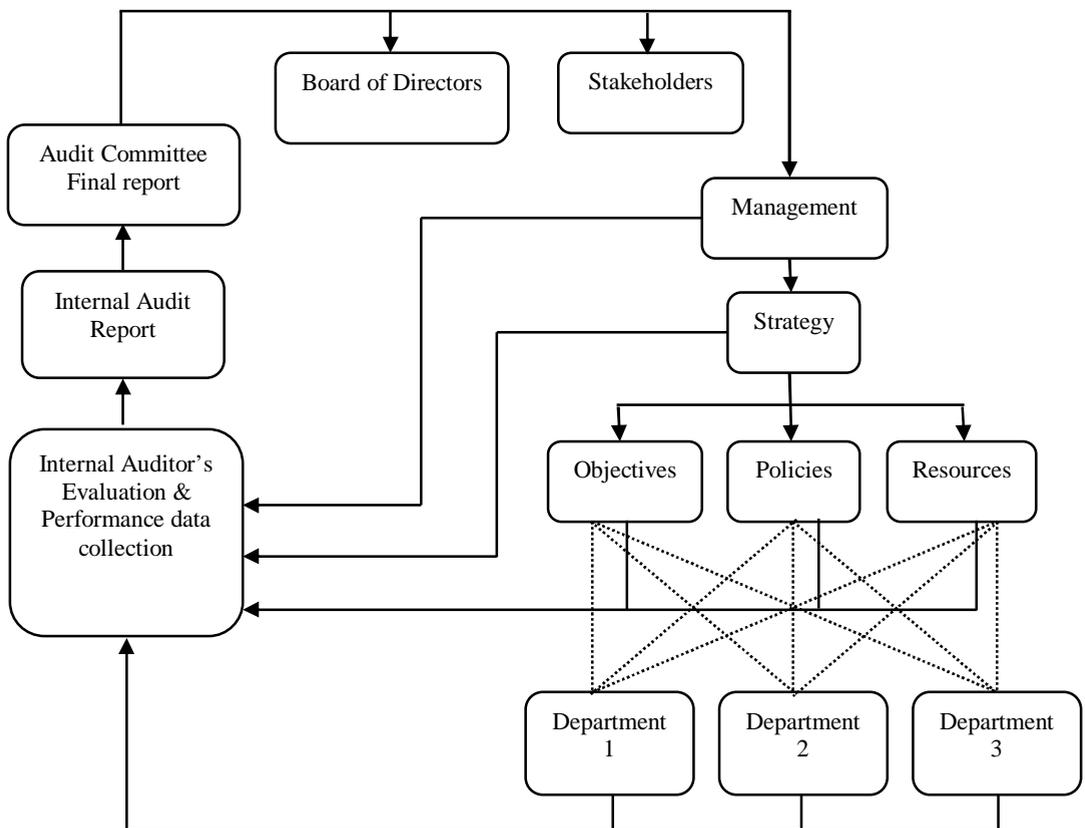
We conclude that, as the chart below displays, the internal audit function and the company's management have an important and mutual beneficial correlation in assuring the execution of decisions that are in the best interest of all.

After all, ensuring a durable governance in any organisation is collective work between (Board of directors, Stakeholders, Management, and Audit). After the selection of a specific strategy and implementing it, departments within the organisation have their fair share of objectives, resources and policies. It is the internal auditor's job, afterward, to launch an investigation and compare the current state of the departments' performance with strategy (objectives, policies and resources) adopted earlier. A full report containing data and statistics will be sent by the auditor towards the audit committee.

The later will direct this report in its final form to the board of directors, stakeholders and top management. The main purpose of this procedure is keeping all those responsible of the organisation informed of the actual path they are taking, and give a chance to correct this path if needed which means a better deliverance of corporate governance.

The next figure illustrate the interactive connection between management and internal audit:

Figure 04: The direct and indirect connections between Management and Internal Audit.



Source: chart made by the author's own illustration.

5. CONCLUSION:

Academic literature and practices on audit and its influence on improving the management of an organisation are gaining more interest in recent years. In this paper, internal audit and its relationship to corporate governance proved that there is a strong correlation between the two. We have illustrated that internal audit function plays an important role with the verification of financial and accounting reports that should deliver a good governance if applied properly. We have discussed as well the vital participation of the auditor concerning inspection and investigation within the organisation for a potential fraud or misconduct of procedures. When it comes to governance, auditors play more preventative role than a detective one. On the other hand, audit committee has a notable impact on the corporate governance when it evaluate and examine financial performances and translating the later to reports containing proposed alternative solutions and recommendations for those in charge of the organisation.

We conclude our analysis by the emphasis on the collective contribution of (auditors, audit committee and management) to build up a strong cooperation regarding the establishment of a solid corporate governance. The outcome of each one is a vital data and information for future decisions.

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¹ Governance Metrics International: Governance Metrics provides institutional investors with corporate governance research and data on over 7,000 public companies worldwide. Asset managers and asset owners can access company profiles, governance scores and underlying governance and accounting metrics to satisfy client investment guidelines, enhance engagement activities and manage potential portfolio risks.