EFFECTIVENESS OF INTERNAL CONTROL SYSTEM IN THE GREEK BANK SECTOR

Dr. Theofanis Karagiorgos¹, Dr. George Drogalas²×, Alexandra Dimou³

Abstract: The globalization of economy, technological advancements, complexity of business and allegations of fraudulent financial reporting have recently sharpened the ever-increasing attention on internal controls and internal auditing. Simultaneously, the capital markets have seen many new financial instruments and players being introduced, making the transactions and operations more complex. In this context, internal audit is to be carried out on the basis of standing laws and regulations, which generally include also the policies and decrees of state as well as rules and by-laws of enterprise. Within this framework of extremely fluid business environment, the purpose of our study is to underline the importance of a well-organised internal control system for ensuring the safe and soundness of a credit institution’s activity, and by this the stability of the banking system as a whole. According to up-to-date theoretical and empirical literature, the results point out that all components of internal audit is vital in the effectiveness of internal audit and consequently in the business survival and success

Keywords: Internal auditing, Auditing, Accounting, COSO, Management, Bank Sector.

JEL Classification: M40, M41, M10.

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1. INTRODUCTION
There is currently considerable interest in the topic of internal audit and its contribution to exact management of any business economic resources (Kantzos and Chondraki, 2006; Rittenberg, 2006). This developing role of the internal auditing is also reflected in its current definition, i.e. “Internal control is the system of internal administrative and financial checks and balances designed by management, and supported by corrective actions, to ensure that the goals and responsibilities of the organization are achieved” (Cahill, 2006).

In accordance with the above, growth in international financial markets has given banks the opportunity to design new products and to provide a wide range of services, there can be noticed an increase in associated risks (Palfi and Muresan, 2009). Simultaneously, there is growing management recognition of the importance of implementing a good internal control system as some of the recent reports on bank failures have highlighted fraud and negligence as the major contributory factors (Chan, 1995). In other words, the activities of internal audit are now seen as critical elements in the assurance process. Strong internal control systems have long been seen as particularly relevant to banks because of their vulnerability to fraud and the links between information systems and money (Cahill, 2006). Despite the aforementioned perspectives of the researchers regarding the crucial role of internal auditing, there is no such a study examining the internal audit function within Greek banks. In this context, the purpose of this paper is to highlight the interaction between components of internal audit and effectiveness of internal auditing in Greek banks, in particular. To accomplish its goal, the study uses survey data from 100 Bank employees. Consistent with our predictions, our results indicate that the success of internal auditing is strongly associated with the five elements of internal control system (Messier, 1997; Candreva, 2006): Control environment, Risk assessment, Control activities, Information and communication and Monitoring.

The remainder of the paper is organized as follows. The next section reviews the related literature and provides the focus of the study by analyzing the effectiveness of internal auditing and presenting the recent empirical literature review. The third section presents the research design by providing information on the development of the survey and the methodology for data analysis. The results of the study are reported and discussed 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. LITERATURE REVIEW
2.1 Theoretical Framework and Effectiveness of Internal Auditing
In order to determine internal audit efficiency evaluation principles it is important to analyze the conceptual framework of internal auditing (Savcuł, 2007). According to the Institute of Internal Auditors, (IIA, 1991; Taylor and Glezen, 1991; IIA, 1995) internal auditing is “an independent appraisal function, established within an organization to examine and evaluate its activities as a service to the organization”. By measuring and evaluating the effectiveness of organizational controls, internal auditing, itself, is an important managerial control device (Carmichael et al., 1996), which is directly linked to the organizational structure and the general rules of the business (Cai, 1997).

Hence, 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”.

Based on the institutional environment, one can conclude that many standards can be used in order to assess the effectiveness of internal auditing. This paper extends the above studies by presenting empirical evidence that evaluate internal auditing by assessing the components (as described by the COSO Report) of internal control system. In line with the above, the five interrelated components (or criteria) are: (Rezaee, 1995; Konrath, 1996; Yang and Guan, 2004): Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring.

Specifically, control environment reflects the attitude and the policies of management in regard with the importance of internal audit in the economic unit. On the one hand, control environment is influenced by the history and the culture of economic unit, on the other hand has a pervasive influence on the way business activities are structured that sets a positive and supportive attitude toward internal control and conscientious management (Aldridge and Colbert, 1994). In regard with risk assessment, it can be claimed that it is the identification and analysis of relevant risks associated with achieving the business objectives (Karagiorgos et al., 2009). Hence, control activities are the policies, procedures and mechanisms that enforce management’s directives (Hevesi, 2005). In line with the above, on the one hand the information and communication component refers to the identification, capture, and communication of pertinent information in an appropriate form and timeframe to accomplish the financial reporting objectives (Aldridge and Colbert, 1994). On the other hand, effective communications should occur in a broad sense with information flowing down, across, and up the organization. Finally, it is commonly acceptable that internal control systems need to be monitored in order to assess the quality of the system’s performance over time. Hence by monitoring, it is ensured that the findings of audits and other reviews are promptly resolved (Rezaee et al., 2001).

2.2 Recent Empirical Literature
As it is mentioned before, internal auditing is a critical component of an organisation’s management and a foundation for its safe and sound operations (Drogalas et al., 2005; Karagiorgos et al., 2010). Banks plays a vital role in economy as they hold the savings of the public provide a means of payment for goods and services and finance the development of business (Siddiqui and Podder, 2002). The growing importance of internal auditing and banking sector has led to systematic research into the factors that improve the performance of internal auditing in Banks. In the light of the above, Celal (1989) examined the internal audit function in the Banks of Turkey. To achieve its purpose the following methodology is used: 25 questionnaires were sent in internal auditors in the Banks of Turkey and 14 were answered (percentage of answers 56%), while 90 different questionnaires were sent in auditors and 50 were answered (percentage of answers 56%). The analysis of the survey answers indicates that the importance of internal audit in the banking sector is increased by the usage of computers and the international extension of Banks. Furthermore, the results show that the number of internal auditors is related with the size of the Bank. Regarding the education of internal auditors, the results reveal that usually internal auditors have graduated from Universities and have studied Accountancy. Finally, the paper highlights the growing importance of internal auditing in business success.

Siddiqui and Podder (2002) examine the effectiveness of financial audit of banking companies operating within Bangladesh. For the purpose of this study, the audited financial statements of 14 sample banking companies have been analyzed. The study identifies seven sample companies that have actually overstated their profits. Hence, the research explores the level of independence, objectivity and competence of the auditors assigned for auditing banking companies.
Abu-Musa (2004) examined the existence and adequacy of implemented security controls in the Egyptian banking sector. The results of the survey pointed out that the vast majority of Egyptian banks have adequate security controls in place. The results also revealed that the computer departments paid relatively more attention to technical security controls; while internal audit departments emphasized more of the behavioural and organizational security controls. Finally, the study provides valuable empirical results regarding inadequacies of implemented CAIS security controls, and introduced some suggestions to strengthen and improve the security controls in the EBS.

More recently, Koutoupis and Tsamis (2008) via a literature review and three case study approaches analyzed the attitude of Greek banks with regard to the application of “risk-based” approach. The Greek Law, the Bank of Greece and international regulations impose internal audit in the Greek Bank sector. However, the Greek banking credit institutions ignored most regulations. The results of the research show that the standards of internal auditing require the adoption of “risk-based” approach from the internal auditors. Unfortunately, this requirement is not being into practice. Thus, the Greek banks adopt an intermediary approach of internal auditing that takes into consideration the risks, without estimating and managing them.

At the same time Khanna and Kaveri (2008) examined the implementation of risk-based internal audit in Indian Banks. To accomplish the goals of the survey, a structured questionnaire was mailed to 43 banks in India, both in the public and private sectors. A total of 25 banks, all public sector banks and six private sector banks, have responded to the questionnaire mailed The findings of the paper point out that the banks have made sufficient progress in introducing RBIA (risk-based internal audit). This refers to their understanding of methodology for assessment of risk, audit procedures and implementation of audit report

Hence, Palfi and Muresan (2009) examined the importance of a well-organised system of internal control in regard with the bank sector. The sample was based on 25 credit institutions of Romania. The analysis of the survey answers reveals that the continuous collaboration, based on periodical meetings, between all structures of bank, characterizes an effective internal audit department.

Finally, Abu-Musa (2010) investigates the existence and adequacy of implemented security controls of computerized accounting information systems in the Saudi banking sector. The results of study reveal that the vast majority of Saudi banks have adequate security controls in place. The results also enable bank managers and practitioners to better secure their computerized accounting information systems and to champion the security of information technology for the success of their banks

3. RESEARCH DESIGN
3.1 Survey Development
To achieve its objective the research uses the exploratory research methods of research questionnaires. This method of data collection was considered appropriate because the information sought is not publicly available and internal auditors are in a good position to know the answers to the questions asked. Then, the questionnaires were sent to the sample of 450 Bank employees. Cover letters and surveys, along with postage paid return envelopes, were mailed directly to each of the Bank employee at each of the 16 Banks. Hence, correspondence was personalized as far as possible; cover letters were hand signed; and envelopes were individually addressed with the name and title of the Bank employee.

3.2 Methodology for Data Analysis
Respondents were asked to indicate their degree of agreement or disagreement with each of the ten statements on a five-point Likert response scale (Likert, 1932) that ranged from
“strongly agree (scored as 5) to “strongly disagree” (scored as 1). A large amount of researchers use this methodology, because it is relatively easy for respondents to use, and responses from such a scale are likely to be reliable (Nunnally, 1978; Myers and Gramling; 1997, Balzan and Baldacchino, 2007; Lam and Kolic, 2008). For all statements, mean responses are obtained from the full sample. A positive mean response more than 2,5 suggests agreement with the statement, a positive mean response less than 2,5 implies disagreement and a mean response close to 2,5 indicates indecision or offsetting differences. All of the statements are coded in such a way that a positive mean response more than 2,5 displays that this component of internal control system influence positively the effectiveness of internal auditing within Greek Banks, while a positive mean response less than 2,5 reveals that this component of Internal Control System does not influence positively the effectiveness of internal auditing within Greek Banks.

4. RESULTS
Finally, of the 450 questionnaires distributed, 100 completed usable questionnaires were returned for a response rate of 22 percent. As mentioned, in this study the effectiveness of internal auditing is assessed via the five criteria that are provided by COSO report (COSO, 1992; Roth and Esperen, 2002; Bowrin, 2004). Hence, for the estimation of each characteristic are used data that comes from five questions.

In this context, “Control Environment” is depicted via 1-5 questions. Regarding the existence of Flowchart, the results reveal that a large amount of employees (31% agree and 45% strongly agree) claim that there is Flowchart for each Department of Bank. In regard with the existence of “Handbook of Processes” the percentages are quite different (48% strongly agree, 24% agree and 22% neither agree nor disagree). Then, the paper examined the description of duties in all levels. The results also show that there is an adequate description of duties (20% strongly agree and 48% agree). In conjunction with the above, the segregation of duties has the same attitude. Finally, the paper discusses the integrity and ethical values of the Bank’s personnel. The results point out that 32% strongly agree that the management integrity and moral beginnings have been declared and communicated in too much big degree, a rate of height 47% answered “in big scale”, rate of height 15% answered “in mediocre scale”, rate of height hardly 4% answered “in small scale” and hardly a 2% answered that have not been declared by no means such beginnings. To be more accurate Table 1 shows descriptive statistics of questions 1-5.

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The second component of internal control is “Risk Assessment”. Firstly, the questionnaire examines the existence of an integrated procedure for the evaluation of risks. The results point out that the first possible answers from the Likert scale (strongly agree, agree and neither agree no disagree) were chosen by 33%, 35%, 20% of the respondents, respectively, as opposed to the other two possible answers (disagree and strongly disagree) that were chosen by the 8% and 4% respectively, of the respondents. The next question examines whether the objectives are clearly linked to and support Bank-wide strategies. From the responses, the vast majority of the respondents believe that objectives flow from the company’s broad strategy.
(85% agree or strongly agree). In contrast with the above findings, the 48 percent of the respondents do not believe that the objectives established by the management are realistic. Then the questionnaire examines the risk identification under special circumstances. The results indicate that the 77 percent strongly agree or agree with the above statement. Finally, question 10 examines whether the extent of internal auditing procedures is proportional to the risk that its department faces. In total 70 percent of the respondents claim that internal auditing mechanism is adapted to the different risk severities within its department. To be more accurate Table 2 shows descriptive statistics of questions 6-10.

**Table 2: Descriptive statistics (Questions 6–10)**

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The component “Control Activities” is described via questions 11-15. Specifically, question 11 examines whether employees understand the extent of their responsibilities. The majority of the respondents answered, “strongly agree” or “agree” (82 percent). The next two questions examine the reliability of information that stem from Bank departments and whether this reliability is linked to the Bank’s information system. In both questions the vast majority (71% and 92%, respectively) of the respondents claim that the internal information system is substantially supported by the administration. In question 14 employees were asked if the established internal control system is able to detect illegal activities from within the Bank. Again, 77 percent of the employees believe that internal audit is efficient in detecting illegal activities. Finally the effectiveness of job description, in regard with internal auditing function, is examined. In this point, it is worth to mention that only 13 percent of the employees totally agree with the above statement. The previously noted findings are also shown in Table 3, where descriptive statistics are presented (Norusis, 1990).

**Table 3: Descriptive statistics (Questions 11–15)**

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The fourth component of internal auditing is “Information and Communication”. Question 16 examines the attitude of the employees towards the flow of information from the staff to the internal auditors. Of the respondents 83 percent believe that the Bank’s employees effectively contribute to the flow of information. In line with the above question 17 assesses the reliability of information from the staff to the internal auditors. Then question 18 examine whether the internal auditors have access to Bank information system. Most of the respondents, (47 percent) answered, “strongly agree”, while another 42 percent answered, “agree”. Question 19 examines if the internal auditing department is being consulted when
the legitimacy of various banking processes is in question. The results are encouraging, although further improvement can be achieved since 36 percent of the employees are opposed to the above statement. The last question considers whether the internal auditors are qualified to effectively resolve issues arising during the auditing process. It is worth noting that none of the employees strongly disagree with the above statement, whereas 64 percent “agree” or “strongly agree”. To be more accurate Table 4 shows descriptive statistics of questions 16-20.

Table 4: Descriptive statistics (Questions 16–20)

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The final component of internal auditing is “Monitoring”. The evaluation of internal auditors functions is examined in question 21. The vast majority of the respondents claim that the administration recognizes the importance of internal auditors work. Further, it is asked (Question 22), in what extent the internal control system is in accordance with the standards proposed by the Audit Committee. Again the 80 percent of the respondents believe that internal auditors follow the Audit Committee’s standards. Then the questionnaire examine in what extent the previous work of internal auditors is revisited in order to evaluate its effectiveness. The results indicate that 57 percent of the staff are sceptic or even disagree with the above statement. Question 24 examine whether applied Bank operations are in accordance with the Bank’s formal policies and procedures. Most of the respondents believe that staff follows Bank’s policy. The last question examine whether an employee can process a transaction from the beginning to the end. It is worth mentioning that 56 percent “agree” or “strongly agree”, while the remaining 44 percent “disagree” or ”strongly disagree”. All the above results are also depicted in Table 5, where descriptive statistics of questions 21-25 are presented.

Table 5: Descriptive statistics (Questions 21–25)

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5. CONCLUSIONS

In today’s highly competitive business environment, internal auditing plays a catalytic role as it is established as an essential mean for the exact management of any business economic resources (Papastathis, 2003; Sarens et al., 2006). Simultaneously, the banking sector is undergoing significant changes as the international economy and dynamic business environment expands towards value chain system (Soliman and Youssef, 2003; Chen et al.,
Within this environment, significant amount of research has been conducted on the effectiveness of internal audit (Karagiorgos et al., 2009). Unfortunately, there is no such a study for the case of Greece and in particular for the banking sector. Hence, as mentioned in previous sections unlike the other researchers who examined factors that affect the performance of internal auditing, the authors of this study extends the present literature by highlighting via empirical evidence the interaction between the components of internal control system (as described by the COSO Report) and quality of Bank’s internal audit.

Overall, from the results, it is important to mention that all the components of internal control system are highly rated. Regarding “Control Environment” the results indicates that integrity and ethical values, Code of Conduct and Flowchart are essential elements of the control environment. However it is worth mentioning that regarding the segregation of duties further improvement can be achieved since 47 percent of the employees believe that segregation of duties is not clearly determined. In line with the above, “Risk Assessment” is considered as a key part of management process which is in place to identify and assess barriers to achieving Bank’s objectives. However it is worth noting that regarding Bank’s objectives, further improvement can be achieved since 48 percent of the respondents do not believe that the objectives established by the management are realistic. Similar to the above findings, the vast majority of Bank employees believe that “Control Activities” is the policies and procedures, which are used to ensure that management directives are met. In this point, it is worth to mention that only 13 percent of the employees totally agree with the effectiveness of job description, in regard with internal auditing function. Hence, in terms of “Information and Communication”, the respondents claim that information is communicated effectively both up and down within the Bank departments. The results are encouraging; although further improvement can be achieved since 36 percent of the employees are opposed to the statement that internal auditing department is being consulted when the legitimacy of various banking processes is in question. Finally, regarding “Monitoring” the vast majority of Bank’s employees believe that Monitoring procedures are an inherent part of the Bank and are performed on a real-time basis reacting dynamically to changing conditions. It is worth mentioning that 44 percent “disagree” or “strongly disagree” with the statement that an employee can process a transaction from the beginning to the end.

As with other studies, the findings of this study should be viewed taking into account its limitations. The sampling area of the study was limited to the Greek Bank sector. A further limitation in carrying out this study, to be taken into account particularly if one is to compare these results to those that may be found in other countries, is the small number of respondents on which the study was necessarily based. Hence, this study provides useful insights on the effectiveness of internal auditing in Greek Bank sector, although only the perceptions of Bank employees were obtained.

Concluding, this research is expected to be one more element to help the formation of opinions and to diffuse other discussions on the subject. While we find a number of interactions between components of internal control system and effectiveness of internal auditing within Greek Banks, it is important to mention that these results are descriptive only. They do not indicate specific mechanisms to enhance the effectiveness of internal auditing. However they provide a basis for further research that may lead toward a better understanding of how the components of internal control system can improve the performance of Greek Banks. Hence, future research can expand the geographical areas of study. In line with the above, perhaps, a future study could be undertaken to explore the perception of other parties such as external auditors or clients on the performance of internal auditing in Greek bank sector. Undoubtedly, it is clear that internal audit will see its great improvement in many management fields (Power, 2004). As the saying goes, “the future is bright, but the road ahead is tortuous”.

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