INTERNAL AUDITING AS AN EFFECTIVE TOOL FOR CORPORATE GOVERNANCE

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ABSTRACT: Within the globalized economy, internal auditing is established as an essential means for the exact management of any business economic resources. Simultaneously, corporate governance has received wide attention in recent years both in practice (Brown, 1999) and in academic research (De Zoort and Salterio, 2001) because of the major accounting scandals and large-scale corporate failures. In this concept, the main purpose of the present paper is to examine in a theoretical level the contribution of internal auditing to corporate governance. Furthermore this paper aims to examine the interaction between various corporate governance factors, such as the board of directors, the audit committee and the external auditor, and the internal audit process. Via an extended literature review, the study’s originality is the provision of an integrated conceptual framework regarding internal audit and business corporate governance. The results of this literature review indicate that internal auditing plays a vital role in effective corporate governance.

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INTRODUCTION

INTERNAL auditing is an integral part of the corporate governance mosaic in both the public and the private sectors (Cohen et. al., 2002).

In order to best examine the relationship between internal audit and corporate governance diachronically, this study proceeds to an historical and behind various argumentations analysis of internal audit activities, attempting...
to sketch out the relationship between the internal audit and corporate governance. The structure of this paper is as follows: the next section discusses the conceptual meaning of the term “internal auditing”. Then section that follows states the theoretical background of corporate governance. Furthermore, the next one analyses the contribution of internal auditing to corporate governance. Finally, the last section contains conclusions, remarks and recommendations for future research concerning internal auditing.

CONCEPTUAL FRAMEWORK OF INTERNAL AUDIT

Historically, internal audit has been considered as a monitoring function, the “organizational policeman and watchdog” (Morgan, 1979), tolerated as a necessary component of organizational control but deemed subservient to the achievement of major corporate objectives.

However, Institute of Internal Auditors, (IIA, 1991; Taylor and Glezen, 1991; Konrath, 1996) defines internal auditing as “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).

In this period, internal audit is defined also by COSO (Committee of Sponsoring Organizations of the Treadway Commission, 1992) as a procedure which offers fundamental security to the business concerning the credibility of financial affairs. The report defines internal control and describes a framework for internal control. However, the crucial difference of this report is that it also provides criteria for the management to utilize so as to evaluate controls (Aldridge and Colbert, 1994).

An important step was the new definition of Internal auditing issued by the IIA in June 1999, which clearly states that “the internal auditing activity should evaluate and contribute to the improvement of risk management, control and governance” (IIA, 1999). The new definition shifts the focus of the internal audit function from one of assurance to that of value added and attempts to move the profession toward a standards-driven approach with a heightened identity (Bou-Raad, 2000; Krogstad et al., 1999).

More recently, the Institute of Internal Auditors (2004) by stating that the internal audit activity should evaluate and contribute to the improvement of risk management, control and governance, recognizes the assurance and consulting role of internal auditing in corporate governance. The Internal Control moves within a greater scope of management philosophy and of practical application, and adds up value, offering at the same time a systematic
scientific approach on the assessment and the improvement of the effectiveness of businesses (Papadatou, 2005; Karagiorgos et. al, 2006).

From the above definitions, it is clear that the internal control is not just an one-sided tool for controlling the order and rightness of certain situations, but it is a method of detecting the value added up to a company, achieving the index of effectiveness and profitability of the company (Nagy and Cenker, 2002; Goodwin, 2004 Karagiorgos et. al, 2007).

**THEORETICAL BACKGROUND OF CORPORATE GOVERNANCE**

While corporate governance has been reflected upon since the beginnings of the modern corporation (Kim and Nofsinger, 2007), it certainly has received increased attention and scrutiny over the last two decades. In this period, corporate governance issues have become important not only in the academic literature, but also in public policy debates. Corporate governance issues are in general receiving greater attention as a result of the increasing recognition that a firm’s corporate governance affects both its economic performance and its ability to access long-term, low investment capital (Mordelet, 2009). Corporate governance ranges throughout countries and firms. A higher quality of corporate governance allows firms to gain access to capital markets more easily, which is greatly significant for firms, which mean to boost their funds.

In this concept, Corporate Governance is defined as the total of operations and controls of an organization (Fama and Jensen, 1983) or as an overall structured system of principles (Dey Committee, 1994) according to which an enterprise operates and is organized, managed and controlled.

John and Senbet (1998) propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. They include as stakeholders not just shareholders, but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart (1995) closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present. First, there is an agency problem, or conflict of interest, involving members of the organization—these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract.

Corporate governance is also defined as the structure and processes among the board of directors, shareholders, top management and other stakeholders, and involves the roles of the stewardship process and exercising strategic leadership, and the objectives of assuring accountability and improving performance (Dunlop, 1998; Sternberg, 1998).
Simultaneously, Cohen and Hanno (2000) using the Public Oversight Board’s perspective, defined corporate governance as “those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process”. This view of governance focuses on the control environment and control activities.

However, the best way to define the concept is to adopt the definition shared by the Organisation for Economic Cooperation and Development (OECD, 2004) countries: “Corporate governance is the system by which a business corporation (or a nonprofit organisation) is directed and controlled, at its senior level, in order to achieve its objectives, performance and financial management, but also accountability, integrity and openness”.

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).

From the above it is clear that the regulation of corporate governance is the government’s attempt to ensure that the corporation pursues its defined purposes and protects the interests of its owners (Chang et. al., 2006).

**INTERNAL AUDITING AND CORPORATE GOVERNANCE**

It is now generally accepted that the correlation between internal auditing and corporate governance affects all kinds of economic activity and that the perceived implications and consequences of this interaction have changed considerably in the recent years. Internal auditing and corporate governance have now become a matter of major public concern. In this concept, international guidelines perceive that effective cooperation of corporate governance and internal auditing improves performance, and is a source of competitive advantage.

The contribution of internal auditing to corporate governance is depicted via demarcating the relationship between internal audit and key elements of corporate governance.

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). The new definition of internal auditing focus on corporate governance, especially the Board of Directors. This definition emphasizes internal’s audit role in aiding the entity to achieve its objectives. 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.

According to Cook and Wincle (1976), the Internal Control System resembles the human nervous system which is spread throughout the business carrying orders and reactions to and from the management. In this concept, 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). In today’s business environment internal auditors are now providing management with a far broader range of information concerning the organization’s financial, operational and compliance activities to improve effectiveness, efficiency, and economy of management performance and activities (Rezaee, 1996).

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.
- 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 (Sawyer, 2003).

From the other hand, an effective audit committee strengthen the position of the internal audit function by providing an independent and supportive environment and review the effectiveness of the internal audit function.

External audit is also regarded as an important cornerstone of corporate governance, particularly with respect to the prevention and detection of fraud and errors in financial statements (Adamec et al., 2005; Davidson et al., 2005). The relationship between internal and external auditors should be one of mutual support and cooperation in order to strengthen overall audit quality and mechanisms of corporate governance (Gramling and Myers, 2003).

Finally internal auditing help corporate governance by reviewing the organization’s code of conduct and ethics policies to ensure they are current and are communicated to employees.
From the above it is clear, that internal auditing develops ever-new approaches to internal auditing, devises new auditing products and services, and helps fulfill increasingly more complex demands that management nowadays faces. Related to that, it can be expected that internal auditing will be increasingly oriented towards advising the management on efficient corporate governance.

**SUMMARY AND CONCLUSIONS**

The area of internal auditing is probably one of the most dynamic and yet important subjects to come to our attention. Internal audit is currently at a crucial stage in its development as there is a growing demand for audit services. What has yet to be formed is a consensus among theory and practise. This research did not have the intention of concluding the discussions over this matter; however, it is expected to be one more element to help the formation of opinions and to diffuse other discussions on the subject. This study has made a first and successful attempt to establish the positive relationship between the broad attributes of corporate governance and internal auditing. The main limitation of this study is that it is not focused on any specific industry sector or organizational size to any great extent. Taking into consideration that the interest in this field of research is rather new, it is necessary that the future orientation of the academics as well as of the practitioners be focused on the evolution of those governance mechanisms which will limit these troubles. For this reason it is recommended further research to take a more focused approach by examining the matters reported in this paper in different areas of industry sectors and organisational size, and evaluate the development of individual elements and steps of the approach. Also further research might usefully refine the actual and potential impact of internal auditing on corporate governance, by examining case studies of internal audit work in practice. Finally, internal audit will see its great improvement in many management fields (Karagiorgos et. al, 2008). As the saying goes, “the future is bright, but the road ahead is tortuous”. Realization of the major importance of internal audit in efficient management will set internal audit as a priceless support in the business management effort.

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