THE ROLE OF INTERNAL AUDIT IN BANK’S M&AS

George Drogalas*, Panagiotis Pantelidis**, Paraskevi Zlatinski** and Dimitris Paschaloudis**

Abstract: Organizations have encountered rapid changes in economic complexity, expanded regulatory requirements, and technological advancements in recent years. These changes have given the internal audit function a set of expanded opportunities to support management and provide services to other organizational functions (Hass and Burnaby, 2006). Simultaneously, recently numerous mergers have been realized. While academics and practitioners have long discussed both internal audit and bank M&As, the relationship between internal audit and M&As continues to be an elusive concept. For this reason, this study aims to provide some insight on the contribution of internal audit to effective M&As procedure. The empirical results affirm the importance of internal audit on bank’s acquisitions activity.

Keywords: Internal auditing, Auditing, Mergers, Acquisitions, Accounting, Bank

JEL Classification: M40, M41, M10.

1. INTRODUCTION

Not surprisingly, a large body of research has examined auditor effectiveness, but this has been predominantly in the context of external audit. In more recent years, there has been heightened interest in issues associated with the effectiveness of internal audit (Bierstaker and Thibodeau, 2006; Dessalegn and Aderajew, 2007; Karagiorgos et al., 2010). The motivation for this growth in research is related to the evolving and expanding role of internal audit as a key corporate governance (CG) mechanism as well as an internal consultancy service (Stewart and Subramaniam, 2010).

Simultaneously, one of the main elements of contemporary corporate restructuring is the boom in mergers and acquisitions (M&As). The strategy literature commonly argues that M&As are one of the mechanisms by which firms gain access to new resources and, via resource redeployment, increase revenues and reduce cost (Eleftheriadis et al., 2008).

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For this reason, the objective of this paper is to provide a review of the evolving literature on internal auditors’ effectiveness in regard with bank M&A in order to highlight gaps in knowledge and make recommendations for future research. Evidence from available literature confirms that very few studies have been done to examine how the internal audit function impact on M&As performance. This paper makes valuable contributions in internal audit literature by systematically demonstrating how internal audit leads to effective M&As procedure.

2. M&A AND INTERNAL AUDITING

On the one hand, 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” (Burnaby and Hass, 2009; Karagiorgos et al., 2009).

On the other hand, M&As are considered as one of the mechanisms by which firms gain access to new resources and, via resource redeployment, increase revenues and reduce cost (Wolf, 2003). In other words mergers and acquisitions are arguably the most popular strategy among firms who seek to establish a competitive advantage over their rivals (Kumar and Bansal, 2008).

3. LITERATURE REVIEW

To avoid replication of previous literature reviews, we do not cover the whole spectrum of internal audit research. Rather, we focus on specific areas of significance to internal audit effectiveness and bank M&As, where we perceive a need for further research.

At first, Cook (1993) examined the role of internal audit in acquisitions before a purchase is made. Specifically, the article looks at the type of review which can be undertaken at the pre-acquisition stage, while a company is gearing up towards diversification. The results point out that internal auditing at the pre-acquisition stage is vital in the effectiveness of M&As. The results also reveal that internal audit should seek to become involved as early as possible.

In this respect, Schraeder and Self (2003) examined the merger procedure before and after completion. The process with the most noticeable effect, in the examination of pre-event period is the lack of efforts to assess the compatibility of the merging
organizations. The paper argues that internal audit should demonstrate greater attention during the process of detailed assessment (due diligence). The results point out that the strategic alternatives do not reflect the ultimate cure for the challenges associated with completed mergers or acquisitions organizations, but are intended to provide a comprehensive overview of strategies, offered by the researchers.

In the same period, Selim et al. (2003) examined the role of internal auditors in M&As. The survey was conducted during 2000 and 2001 and included interviews in 6 countries. The survey indicates a low level of involvement of internal auditors at the various stages of mergers and acquisitions (M&AS). Hence, the research reveals a desire by internal auditors to become more involved with M&A projects and to become associated with these activities at an earlier stage. In other words, the study sets out the pre-requisites for internal auditors expanded role and discusses the means of achieving this.

Similar to the aforementioned studies, Dounis (2006) also describes the involvement of internal auditors in M&As. The study examined the present level of involvement of the internal audit function during M&A activity and compared it with internal auditing’s preferred levels. The research used a questionnaire which was mailed to 120 chief audit executives in leading edge organizations that participated as bidder companies in M&As between 2000 and 2003. Thirty-four of the questionnaires were completed and returned. This comparison led to the identification of possible reasons for the low level of involvement and means and prerequisites for internal auditing participating more actively. To be more comprehensive, Table 1 depicts a short review of the literature by presenting the authors, the scopes and the basic outputs of the aforementioned studies.

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. The survey concluded that complementarities and constant cooperation based on regular meetings between all control units (such as supervisors, internal and external auditors), provided that a very well organized structure is preceded, in order to ensure an effective I.A.

More recently, a research on the productivity in the banking sector held by Chatzoglou et al. (2010), based on data for the period 2004-2006. The effectiveness of the Greek banking system appears to be stable, while large banks perform better than small ones. The conclusions presented are very important for bank managers, which want to predict short-term developments. In this study, the characteristics of the Greek banking sector have been examined. In this respect, two of the
characteristics of the Greek banking sector for the period 1997-2007 were: (1) the number of mergers and acquisitions that took place and (2) the rapid growth strategy took place at an international level (mainly in the Balkans), which have seriously affected the efficiency and profitability of Greek banks during the reporting period.

To be more comprehensive, Table 1 depicts a short review of the literature by presenting the authors, the scopes and the basic outputs of the aforementioned studies.

### Table 1
**Short Review of the Literature**

<table>
<thead>
<tr>
<th>Authors</th>
<th>Scope</th>
<th>Basic Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook (1993)</td>
<td>The role of internal auditors at the pre-acquisition stage.</td>
<td>Internal auditing at the pre-acquisition stage is vital in the effectiveness of M&amp;As.</td>
</tr>
<tr>
<td>Schraeder and Self (2003)</td>
<td>The role of internal auditors in M&amp;As.</td>
<td>Internal audit should demonstrate greater attention during the process of due diligence.</td>
</tr>
<tr>
<td>Selim et al. (2003)</td>
<td>The role of internal auditors in M&amp;As.</td>
<td>Internal auditor's involvement in M&amp;As can only be described as moderate.</td>
</tr>
<tr>
<td>Dounis (2006)</td>
<td>The role of internal auditors in M&amp;As.</td>
<td>Internal auditors are seeking more proactive involvement in mergers and acquisitions.</td>
</tr>
<tr>
<td>Palfi and Muresan (2009)</td>
<td>The role of internal auditors in banks</td>
<td>The continuous collaboration between all structures of bank, characterizes an effective internal audit department.</td>
</tr>
<tr>
<td>Chatzoglou et al. (2010)</td>
<td>The role of internal auditors in banks</td>
<td>The effectiveness of the Greek banking system appears to be stable.</td>
</tr>
</tbody>
</table>

4. **RESEARCH DESIGN**

The researchers first made a phone call to potential respondents requesting their participation in the study. A copy of the research instrument, including a prepaid self-addressed envelope, was then distributed to those who agreed to participate.

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 (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.

5. RESULTS

A total of 285 questionnaires were mailed, however a total of 62 responses were received, yielding a response rate of 21.7 percent. As mentioned, in this study the effectiveness of internal auditing is assessed via three categories. Half of the respondents were between 41-50 years of age, with a further 43% between the age of 31-40. The mean working experience of respondents in their present organization was 6.9 years with the longest being 24 and the shortest being 3 years.

Questions 1 -5 deal with the general evaluation of internal audit. The results revealed that internal audit plays significant role in Bank sector. Descriptive statistics concerning the relationship between the internal audit function and the bank M&A are summarized in Table 2 – 6. More specifically, Table 2 reports the finding from questions 6–12.

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Q.6</th>
<th>Q.7</th>
<th>Q.8</th>
<th>Q.9</th>
<th>Q.10</th>
<th>Q.11</th>
<th>Q.12</th>
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<tr>
<td>N Valid</td>
<td>62</td>
<td>62</td>
<td>62</td>
<td>62</td>
<td>62</td>
<td>62</td>
<td>62</td>
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<tr>
<td>Missing</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>4.42</td>
<td>4.03</td>
<td>4.68</td>
<td>4.74</td>
<td>4.19</td>
<td>3.10</td>
<td>4.55</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>.841</td>
<td>1.130</td>
<td>1.037</td>
<td>.848</td>
<td>1.185</td>
<td>1.155</td>
<td>.953</td>
</tr>
</tbody>
</table>

The results affirm the importance of internal auditing, as internal audit not only identifies specific companies targeted for merger and coordinate, but also contributes to develop a plan for M&As. However, the respondents believe that internal audit should develop models to eliminate risk.

The questions 13 – 18 examined the role of internal audit during a specific merger. The results are shown in Table 3.
The findings also show the significant role of internal audit during M&As. However, a vast majority of respondents believe that internal audit does not estimate the risk of failure. In line with the above, internal audit should test the proposed M&As procedure under the criteria of shareholder.

Questions 19 – 23 examined the impact of internal audit on the construction of the merger deal. To be more accurate Table 4 shows the descriptive statistics.

Table 4
Descriptive Statistics (Questions 19–23)

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Q.19</th>
<th>Q.20</th>
<th>Q.21</th>
<th>Q.22</th>
<th>Q.23</th>
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</thead>
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<tr>
<td>N Valid</td>
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<td>62</td>
<td>62</td>
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<tr>
<td>Missing</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>4.17</td>
<td>3.77</td>
<td>4.28</td>
<td>4.30</td>
<td>4.21</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>1.137</td>
<td>.975</td>
<td>1.049</td>
<td>1.211</td>
<td>1.157</td>
</tr>
</tbody>
</table>

From the responses, the vast majority of the respondents believe that internal audit contribute significantly to the construction of the merger deal. The results are encouraging, although further improvement can be achieved since respondents believe that internal audit is represented on the deal Negotiating Team “in an average level”.

Then, questions 24 – 28 deals with the post merger integration. The results are shown in Table 5.

Table 5
Descriptive Statistics (Questions 24–28)

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Q.24</th>
<th>Q.25</th>
<th>Q.26</th>
<th>Q.27</th>
<th>Q.28</th>
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<tbody>
<tr>
<td>N Valid</td>
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<td>62</td>
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<tr>
<td>Missing</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>4.11</td>
<td>4.13</td>
<td>3.90</td>
<td>4.03</td>
<td>4.20</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>.776</td>
<td>.949</td>
<td>1.155</td>
<td>1.071</td>
<td>.970</td>
</tr>
</tbody>
</table>
From the results, it appears that internal audit’s role during the post merger phase is also important. However, most of the respondents believe that internal audit should contribute to the development of the human resources of the new organization.

Finally, questions 29 – 33 examined the merger’s audit. To be more accurate, Table 6 shows the descriptive statistics.

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Q.29</th>
<th>Q.30</th>
<th>Q.31</th>
<th>Q.32</th>
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<tr>
<td>Missing</td>
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<td>0</td>
</tr>
<tr>
<td>Mean</td>
<td>3.84</td>
<td>4.27</td>
<td>4.55</td>
<td>4.10</td>
<td>4.17</td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>1.148</td>
<td>1.109</td>
<td>1.111</td>
<td>1.036</td>
<td>1.419</td>
</tr>
</tbody>
</table>

Similar to the above sections, internal audit plays decisive role in the efficient M&As. However, the findings displayed that should internal audit should evaluates the final outcome comparing to the primitive objectives.

6. CONCLUSIONS

The technological advancements, globalization of economy, allegations of fraudulent financial reporting and increased competition have recently sharpened the ever-increasing attention on internal controls and internal audit functions (Khas, 1999; Melville, 2003; Allegrini et al., 2006). Hence, in the past two decades, European banking markets have been subjected to structural changes, which were caused by modifications in the external environment, especially as a consequence of increasing monetary and financial integration (Allen and Song, 2005; Staikouras and Koutsomanoli, 2006). In line with the above, as markets develop, the aim of achieving rapid growth through the purchase of existing companies has become increasingly popular. Therefore, mergers and acquisitions are considered to be an important aspect of strategic financial management (Melville, 2003).

Despite the aforementioned perceptions, until now a limited research has been conducted on the relationship between M&As and internal audit. As it was mentioned before, in accordance with the recent theoretical literature, the results indicate that internal audit is of major importance for the efficient M&As activity. On the contrary, further improvement can be achieved regarding the internal audit’s role in risk elimination and human resource’s development.

However, the results of this study should be interpreted with caution. There are several limitations to this study, and further investigation of the topics raised
within the study is warranted. The main limitation of this study is that it only examines the relationship between internal audit and bank M&As. Further the empirical results derived only from Greece. For this reason future research should expand the geographical area of the study. In line with the above, perhaps, a future study could be conducted to explore the interaction between internal auditing and M&As in business units. Undoubtedly, the role of internal audit as a key M&As mechanism is continuing to develop and strengthen. As the saying goes, “the future is bright, but the road ahead is tortuous”.

REFERENCES


