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The Contribution of Internal Audit to the Improvement of Corporate Governance

Ikram Lamkaraf, Houria Zaam

Abstract— corporate governance has given, and still gives rise to numerous arguments regarding the definition, but also the purpose of establishing a governance system. Following the financial scandals that have affected several large global companies, internal audit has become an essential tool for a company's governance system.
The main objective of this research is to theoretically examine the contribution of internal audit in the improvement of corporate governance. The originality of this study lies in the provision of an integrated conceptual framework, concerning internal audit and corporate governance. The results of this documentary analysis prove that internal audit plays an essential role in the improvement of corporate governance, through evaluation of the internal control system, risk management and reduction of the information asymmetry between the different stakeholders of a company.

Index Terms— Corporate governance, internal audit, risk management, internal control, information asymmetry, agency theory, board of directors.

1 Introduction

FOR many years now, corporate governance has become a key topic in organizational management. It holds an important position within companies, especially due to several financial scandals (Enron, Vivendi, Worldcom, Lernout and Hauspie…) that have affected United States, Europe and also Japan. The scandals that occurred have contributed to questioning some of the foundations of capitalism: equity, trust, transparency, because of economic actors (auditors, financial analysts, journalists…) who did not respect essential rules, and ignored practices in the context of a boom in the stock market and the new economy. According to Turba, 2007 [1] the "new economy" in United States defines the growth driven by new technologies and is characterized bythe absence of inflation, full employment and the conquering of the world.
In order to respond to the malfunctions caused by this wave of resounding bankruptcy in many countries around the world, and to manage companies in a more transparent way, especially regarding financial data, and to help them create value; many international institutions are involved in publishing several codes of good governance.

Amongst the arguments concerning corporate governance, there are those according to which corporate governance is a way to manage conflict of interest [2], or even a set of mechanisms allowing to have a greatest potential of value creation, through learning and innovation. [3]

Corporate governance is another rich field for analysis and research. Today, internal audit has become an important mechanism in this procedure. The agency theory considers it as a conflict management mechanism [4]. Therefore, it can be asserted that internal audit plays a leading role in reducing information asymmetry, as well as in even distribution of power due to the presence of the audit committee.

In addition, new requirements of the Sarbanes Oxley (SOX) law of July 2002 in United States, and the Law of Financial Security (LSF) of August 1st 2003 in France regarding internal control matters, have enhanced the contribution of internal audit in the improvement of corporate governance. And this by being involved in the preparation and production of the report of internal control.

The rest of this paper is structure as follows: First and foremost, the theoretical background of corporate governance is being analyzed, followed by a presentation of the conceptual framework of internal audit. Finally, the relationship between internal audit and corporate governance is presented in terms of information asymmetry, of risk management and of internal control evaluation.

2 Theoretical Context of the Corporate Governance

Even though the term of « corporate governance » is currently universally used, there is still no official definition. According to Cadbury's report [5]:

The corporate governance is the system according to which companies are managed and controlled. The Board of Directors is responsible for the governance of its company. The role of shareholders in governance consists in assigning directors and auditors, as well as in making sure that there is an appropriate governance structure. The administrators' responsibilities mainly lie in defining the company's strategic objectives, in ensuring the necessary management for their achievement, in supervising corporate management and in providing a report to shareholders' on the performance of the directors. The actions of the Board of Directors are subjected to law, to regulations as well as to the shareholders in the general assembly.

In 1997 Chareaux defined corporate governance as "*the group of mechanisms that have the effect oflimiting the power and influencing the decisions made by the leaders, or in other words, the mechanisms that govern their conduct and define their discretionary space*". For the Institute of Internal Auditor (IIA) [7], the corporate governance is defined as "*the combination of procedures and structures applied by the Board of Directors with the purpose of in-*

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forming, managing and supervising the organization's activities, in order to achieve their objectives".

In 1998 John and Senbet [8] proposed a more comprehensive definition, according to which corporate governance deals with mechanisms through which the stakeholders of a corporation are able to control corporate insiders and management, with the purpose of protecting their own interests. They define stakeholders not only as shareholders, but also as debt holders, but even non-financial stakeholders such as employees, suppliers, customers, and other interested parties.

Therefore, the corporate governance refers to the group of regulations and systems governing, on the one hand, the relationship between the shareholders and the managers; and on the other hand, between shareholders and other stakeholders, whose purpose is to protect the interests of these different parties.

3 The Conceptual Framework of Internal Audit

The concept of audit is an old one, whose objective used to be the verification and the protection of financial statements. That is the reason why the audit mission has been long related to the Court of Auditors. As Mikol once said, 2000 [9], it is a question of financial audit. However, internal audit has been developed following a long evolution, during which it has been able to acquire enough maturity [10]. It is today considered a synonym to objectivity, to efficiency, and an assisting tool for decision making, and that thanks to the recommendations it has received. According to Candau "*audit controls the controls*" [11], which means that it is required to measure and evaluate the efficiency of the internal control system of a company.

The IIA international association which federates the national internal audit institutes defines internal audit as "*an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process.*"The concept of governance is present in this definition of internal audit. Thus, the function of the internal audit appears as a major actor of corporate governance.

"*Internal audit is a permanent and active instrument of corporate governance because we recounted it in the financial accounting, operational, commercial and IT functions. Internal auditing is a profession that has always redefined itself throughout time, given the wish to meet the ever-changing necessities of the enterprises. In time, a shifting in the objectives of the auditing occurred from focusing on the financial accounting problems of the enterprises to identifying the risks and evaluating the internal control to currently holding a position of evaluation and counselling. Through the activities unfolded, the internal auditing adds value both by evaluating the internal control system and by analysing the risks associated with the auditable activities, as well as through the recommendations to be found in the auditing report drafted and transmitted in order to ensure that the organization meets its objectives.*"L.(C).A. Narcisa and H. Elena, 2017 [12]

4 Relationship Between Internal Audit and Corporate Governance

According to Gramling and al, 2004 [13], corporate governance comprises four components: the external audit, the audit committee, the management and function of the internal audit. The contribution of the internal audit function in the improvement of corporate governance could be appreciated through the relationship it maintains with the other three components of corporate governance. In addition, the role of internal audit in the improvement of corporate governance should be appreciated in three levels: in level of information asymmetry reduction, in level of the internal control system evaluation and in level of risk management.

4.1 In Level of Information Asymetry Reduction

The study of the problems related to the agency relationships, finds its origins in Adam Smith's interrogations (1776) on the efficiency of companies whose management was entrusted in a non-owner agent. Berle and Means (1932) extended the discussion by proving that the separation of the owner and the control leads to a situation where divergent interests between owners and managers are problematic [14]. Indeed, Jensen and Meckling (1976) define agency relationships as a contract by which one or several people (the senior) engage another person (the agent) in order to carry out services on their behalf, giving some authority for decision making to the agent [15]. Due to its nature, the agency relationship creates a challenge in the extent where the personal interests of the principal (shareholder) and the agent (manager) are divergent. This relationship as it has been defined in the agency theory is asymmetric, which means that the two parties do not have the same objectoves[1]. Among the conflicts of interest that are likely to arise between the shareholders and the managers, there is that of the information asymmetry (information imbalance) between the agent (manager) and the principal (shareholder). Nevertheless, one can speak of information asymmetry between the two parties when in an exchange the one has access to a private information that the other does not. According to Gomez, 1996 [16] "information asymmetry is…the origin of the contractual relationship". It favors the opportunism that is based on an incomplete, deformed and falsified disclosure of information by an agent, especially on his abilities, his preferences and intentions, and, therefore, on the existence of information asymmetry among the agents.

According to Charreaux, 2000 [17], the information whose recipients are the shareholders is a late information. Its informative content is pour. However, it has been admitted that compared to the shareholders, the manager has, in addition to the accounting and financial data, complete information from management accounts the internal audit report of which he is the only recipient. Therefore, shareholders suffer a double asymmetry of both quantitative (no information released by the financial accounting network) and qualitative information (the information provided does not permit decision making and controlling the directors) [18]. Faced with this information asymmetry, whose victims are the shareholders, Fama, 1980 [19], assumes that directors are able to withhold accounting, financial and social data, manipulating or delaying their re-

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lease.

However, in a world where one cannot be fully informed neither has he the capacity to understand everything and to analyze every information he receives, opportunistic behaviors appears ex ante -by trying to withhold information- or ex post –by taking advantage of the elements that are not written in the contract- in order to personally benefit from the agency relationship. A manager, for example, in order to protect himself from any revocation, chooses a strategy called "entrenchment" which consists in making it difficult(if not impossible) to replace the director, which can be achieved by proceeding for example to investments in projects whose return in profit depends on their presence at the head of the company. The manager can also increase uncertainty regarding the characteristics of the investment, so as to discourage potential leaders from agreeing to engage in a project of unknown and uncontrolled risks.

On the other hand, the agency theory does not take into consideration the bilateral interests of the shareholder or the investor (senior) and the manager or the director (agent), and is therefore neglecting the other stakeholders, namely employees and third parties. Indeed, according to Chatelin&Trebucq (2003): "…the investors, shareholders or banks, are far from being the only victims." [20]. The two authors assert that if the shareholders are at risk of losing their invested money, the other stakeholders also face a part of the risk, for example the employees could lose their jobs (especially in countries where there is unemployment), or eventually their pension savings. This means that, when investors offer their financial capital, there are other stakeholders, like the employees, who offer workforce or human capital.

Pigé, 1998 [21] has identified three levels of information asymmetry, related to corporate governance : the information asymmetry between the managers and the shareholder representatives, the information asymmetry between the shareholders and their representatives, the directors,and a third level of asymmetry which appears when a company's shareholders wish to offer hares to the public market. Internal audit allows the reduction of these three levels of information asymmetry. Internal audit, since it has always been attached to the general management has not been considered by the agency theory as a mechanism for reducing information asymmetry related to corporate governance. Sawyer, 1973 [22], considered the function of internal audit to be the eyes and ears of general management. But since the release of the RSA, by requiring the president of the board of directors or the supervisory authority to produce a report of the internal control, and reporting line betweenthe internal audit andthe board of directors and/or the committee of audit, offers the possibility to the internal audit to now contribute to the reduction of information asymmetry, which exists between the different stakeholders of corporate governance. Indeed, the existence of an audit committee, as the report recipient of the internal auditor, appears to be the communication channel between not only the external but also the internal auditors and the board of directors. The connection of the internal audit and the board of directors and/or the audit committee is an essential condition for the contribution of internal audit to the reduction of information asymmetries in the corporate governance.

4.2 In Level of Risk Management

The report of the Committee of Sponsoring Organization of the Treadway Commission (COSO) defines risk management as "*a process implemented by the board of directors, the general management, the management and the entire workforce of the organization. It is taken into account in strategy development as well as in all the activities of the organization. It is designed to identify potential incidents which are likely to affect the organization and to manage the risks within the limits of its risk appetite. It aims to provide a reasonable assurance of the achievement of the company's objectives* [18]. The process of risk management aims to help the company achieve its operational objectives. In this context, the corporate governance system cannot remain indifferent to the process of identifying, preventing and managing risks. Consequently, better risk management cannot be achieved without sharing information among the different actors of corporate governance (the employees, the managers, the members of the board of directors…).

Kaouthar and Zéghal, 2005 [23], have defined relationships between corporate governance and risk management. The principal relationship according to these authors, consists in the obligation of the managers to provide up to date and relevant information to the board of directors and to the financial controllers, regarding the most important risks that the company is facing and the efficiency of the procedures of risk management the company adopted, once uncertainties appeared. Another identified relationship, encourages the manager not only to disclose the risks but to also to reduce, if not to eliminate them. Regarding the internal audit, it has an important role to play also in risk management. It is the most suitable to provide the board of directors with information concerning the weaknesses of the internal control system, or concerning the risk zones likely to harm the achievement of the strategic, operational, informational objectives and the compliance.

According to Gramling and Myers, 2006 [24], internal audit influences five components of the company's risk management. It gives a reasonable assurance regarding risk management, whether the risks are properly evaluated, whether the risk management procedures have been properly evaluated, whether the report on major risks has been created, and whether a report on the management of the main risks has been drawn out. The results of their study show that internal audit currently plays only a moderate role in risk management. This role is called to be significantly developed in order t evaluate the company's risk management procedures. Nevertheless, the international norm of the internal audit (2100-3) emphasizes that the main objective of internal audit remains the evaluation of the risk management procedures, therefore the internal control evaluation which is the "final product". An efficient internal control means risk control. And once the internal audit achieves to help the company's risk management, it will contribute to the creation of value.

4.3 In Level of Internal Control Evaluation

According to COSO, internal control is a process implemented by the board of directors, the leaders and the workforce of a

company, destined to provide a reasonable assurance regarding the realization of the following objectives:
- The realization and optimization of operations;
- The reliability of financial data;
- The compliance with applicable laws and regulations;

The internal control includes the sense of operations verification and management and extends to all the activities of the company.

Renard. 2010 [25], while analyzing the international norms of the internal audit (2120.A1) which recommend the internal audit to evaluate the risks related tocorporate governance, notices that the points on which the auditor should focus in while evaluating, are the same with the general objectives of the internal control (the reliability of the financial data, the efficiency of the operations, the protection of the actors and the respect to laws and regulations). That is to say that to evaluate the risks related to corporate governance is to verify the internal control quality of the organization: this relationship is deduced between the two factors: an efficient internal control implies an improved corporate governance.

Furthermore, an efficient internal control system, is an integral part of the whole system of corporate governance. In this regard, it should operate aiming to achieve the objectives of the governance (reassure the reliability and the efficiency of the financial data as well as protect the stakeholders' interests). The IIA indicates in 1989 that it is the internal auditor who is responsible for the company's evaluation in order to guarantee its efficiency. It is partly up to the internal audit to verify that the procedures exist, that they are applied by the employees, that they are efficient, and to make recommendations for their improvement. Internal audit continuously monitors the effectiveness of internal controls in the company, in order to give a reasonable assurance to the board of directors and to the general management, that the risks are being handled.

According to Sourour, 2011 [26] the importance that the internal control has seen has also caused an increase of interest regarding the function of internal audit, and that already since 2001. This can be explained by the fact that internal auditors play an important role in the evaluation of the internal control systems, which contributes tomaintaining a satisfactory level of effectiveness. Because of their position within the organization and the authority that they have acquired, internal auditors often play an important role in monitoring the internal control system. They proceed to direct evaluation of the internal control system and recommend improvements. They proceed to the direct examination of the internal control system and give recommendations for its improvement.

However, following the worldwide financial scandals, which have appeared because of the ineffectiveness of the internal control system; numerous laws have been applied in order to guarantee this system's effectiveness and its evaluation by the internal audit. SOX and LSF, require the internal audit to participate in the preparation of the report of the administration concerning the effectiveness and the efficiency of the internal control system within the company, and that by:

- Monitoring and evaluating it;
- Informing the administration about the strengths and weaknesses of the system;

In order for the internal audit to overcome the challenge of ineffectiveness in internal control, imposed by rules of the LSF and SOX, it first has to become a quality audit function.

In addition, the international norms of the internal audit [27] indicate that:

- Norm 21030: internal audit should help the organization maintain an appropriate control mechanism by evaluating its effectiveness and efficiency and by encouraging its continuous improvement;
- Norm 2130.A1: internal audit is responsible for the evaluation of the suitability and the effectiveness of the internal control system chosen in order to face the risks related to corporate governance, operations and information systems of the organization. This evaluation should be made on the following aspects:
  - l'atteinte des objectifs stratégiques de l'organisation;
  - l'efficacité et l'efficience des opérations et des programmes ;
  - la fiabilité et l'intégrité des informations financières et opérationnelles ;
  - le respect des lois, règlements, règles, procédures et contrats.
  - la protection des actifs ;

- Norm 2120.A2: the internal audits should determine the limits within which the goals and objectives concerning the operations and projects have been set, and if those goals and objectives are in alliance with those of the organization;
- Norm 2120.C1: during consulting mission, internal auditors examine the internal control procedures in relation to the objectives of the mission, and focus in the existence of any significant control weakness.

In fact, the company should have adequate control systems, in particular risk management and operational and financial control, as well as respect the applicable laws and norms. One way to achieve these objectives is to establish an internal audit system, under the direct responsibility of the board of directors and/or the audit committee.

5 Conclusion

In the context of corporate governance, we could consider internal audit not only as a control mechanism in the service of the company, allowing the reduction of information asymmetry among the company's different stakeholders, but also as a mechanism evaluating the internal control system's efficiency, as well as identifying and evaluating risks incurred by the company. For that reason, it inspires trust, reassures and establishes its legitimacy alongside all the stakeholders of the company.

Furthermore, we could that the function of the internal audit

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improves the efficiency and the performance of the company, by increasing its responsibilities and by forming an audit committee capable of having an impact on the reliability of this function through the internal control and the supervision it is supposed to offer. Following this literature review, we conclude by stating that there is a close and favorable relationship between the function of the internal audit and the improvement of corporate governance. Other research works could also affirm the real and potential impact of the internal audit in the improvement of corporate governance, by examining case studies regarding the work of internal audit in a practical level.

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