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Does the quality of internal audit matters? A corporate governance perspective

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Abstract

The prime objective of the current study is exploring the role of internal audit quality in activating the principle of corporate governance for the sample of Iraqi listed manufacturing firms via statistical research methodologies such as Logit regression and Correlation analysis. The results indicate that along with independence, it is mandatory to have a qualified person on a board committee. Similarly, the frequency of audit committee also appears in positive relation to corporate governance practices for the sample of Iraqi firm. In conclusion, the results of the study provide support with agency theory.

Keywords: Iraq, Internal Audit, Corporate Governance.

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¿Importa la calidad de la auditoría interna? Una perspectiva de gobierno corporativo

Resumen

El principal objetivo del presente estudio es explorar el papel de la calidad de la auditoría interna en la activación del principio de gobierno corporativo para la muestra de empresas manufactureras en la lista iraquí a través de metodologías de investigación estadística como la regresión Logit y el análisis de correlación. Los resultados indican que junto con la independencia, es obligatorio tener una persona calificada en un comité de la junta. De manera similar, la frecuencia del comité de auditoría también aparece en relación positiva con las prácticas de gobierno corporativo para la muestra de la firma iraquí. En conclusión, los resultados del estudio proporcionan apoyo con la teoría de la agencia.

Palabras clave: Irak, Auditoría Interna, Gobierno Corporativo.

1. INTRODUCTION

The recent episodes of Asian financial crisis and subsequent event of subprime crisis have raised certain questions on the ways organizations are being governed and control. The world has observed a wave of corporate reforms in its different parts. The prime objective of these reforms was to strengthen the internal and external governance mechanisms of corporations. In an effort of doing so, they have introduced codes of corporate governance. According to Dewing and Russell (2004), corporate governance is a mechanism which not only ensures the health of the relationship between different stakeholders but also ensures the transparency among these relationships. Transparency is at heart of any effective corporate governance mechanism. The codes of corporate governances around the world are devising different mechanisms to ensure transparency in corporate governance. Internal audit is one of those devices. Transparency is a precondition for any effective code of corporate governance. The Dawn of the twenty-first century has witnessed a series of corporate scandals such as Enron and World.com. The inquiry reports of these scandals highlighted the weak internal governance and misreporting of financial record as a major reason behind these reforms. The weak, ineffective or in some cases absent internal audit department helped the executives to pursue their self-interest at the cost of shareholders wealth.

As discussed earlier than around the world aftermath of the crisis. It is observed that the development of a code of corporate governance in developed countries is in pace with developing countries. However, in terms of implementation, the developing counties are far behind the developed countries. The current study is being carried out in the Iraqi context. Till to date, Iraq has no formal code of corporate governance. Along with that, it is evident from the literature that Iraq is among most corrupt counties of the world and ranked 5 among most corrupt countries and stands at 171 out of 175 countries. The corruption is deeply rooted in every segment of society. The corporate sector is also badly corrupted. An effective internal audit is a solution to corporate corruption scandals. The effectiveness of the internal audit department is key for transparency in governance. Many prior researchers Roussy & Brivot (2014) has argued in the wake of corporate scandals and financial crisis the internal audit has emerged as a solution to wake internal control.

2. LITERATURE REVIEW

The agency theory argues that manage in any firm are agents which are hired by owners or shareholders to maximize their wealth. Agency theory view, ownership concentration, efficient board and effective audit committees as a proxy of internal governance. Following Peasnell et al. (2000) argued that corporate governance is a mechanism which helps the regulatory authorities and stakeholders in eliminating agency issue and promoting accountability by preventing corruption and fraud. The code of corporate governance around the world are increasingly imposing restrictions to improve internal governance mechanism. Human resource and internal audit committee to scrutinize the affairs of internal audit and recruitment functions are being formed in financial and non-financial corporations.

An audit committee is a subcommittee among a few major committees formed by companies under the supervision of the board of directors. The prime duty of this committee is to make sure that the financial matters of the company are being carried out in the most effective and efficient way. The board of company usually direct and controls the company, and it is their duty to assign competent and qualified director as head of the committee. The concept of the audit committee is a new concept and has emerged in the last decade of the last century. Peasnell et al. (2000) argued that the efficient audit committee is at the heart of an effective code of corporate governance. However, he was the first to broach the issue that only the existence of audit committee is not sufficient to ensure the transparency, rather it will be efficient it must be led by an independent and qualified director. Davidson et al. (2005) shown consistency with the view broached by the Peasnell et al. (2000) that the competency and independence of an audit committee is a precondition of an effective code of corporate governance mechanism. Many Prior researchers Chang & Sun (2009) found that the competency and independence of audit committee place a significant and positive impact on the effectiveness of the audit committee. In addition to the above-mentioned factor, the communication between the internal audit department and external audit department is very important. According to Peasnell et al. (2000), the audit committee is a platform which helps the board to comply with accounting standards and code of corporate governance. They continued and argued that an effective audit committee helps the organization to install an effective control mechanism which reduces agency cost and encourage best practices. To have good corporate governance, audit committee needs resource persons to act as independent director on whose shoulder lies the responsibility to take the company in the right path, demand for more disclosures, transparency and accountability and performance standards for investors and lender and protection for shareholders.

According to Ghafran & Osullivan (2017), the audit committee is a pivotal pillar of a sound and effective code of corporate governance. They continued and argued that the performance of the audit committee is dependent upon the independence and competency of the audit committee. They continued that audit committee by bringing transparency and reducing agency cost makes the code of corporate governance more effective. Researchers indicate that there is a significant difference in the recommended structure and the role of audit committees. The establishment of an audit committee within a company is a core component of corporate governance. Therefore, from the above discussion, we can hypothesize the following relation Audit Quality plays an important role in the effectiveness of the code of corporate governance (Ghafran & Osullivan, 2017). The quality of the audit is dependent upon both the quality of internal audit and external audit. This view is confirmed by Deangelo (1981) who separated audit quality in term of an activity into two stages; firstly, the ability of auditor in the detection of an error and secondly efficiently and correctly reporting that inequalities. They continued this argument and added audit independence as a hallmark of audit quality. Davidson and Neu (1993), argued competency and expertise of internal audit as determinants of quality of the internal audit. Carcello et al. (1992) given 12 factors as determinants of audit quality. The most important of these is the ability to comply with the accounting standard, the composition of the audit team, leadership support, competency of internal audit. Regoliosi and Deri (2012) shown consistency with Carcello et al. (1992) and argued competency and independence of internal audit as the most important determinants of audit quality. Peasnell et al. (2000) argued that a high ratio between the auditors and the total employees of the organization seems to be a crucial indicator of internal audit quality.

Bouraad (2000) highlighted a unique dimension of audit quality by claiming it is a core function of providing information required for a code of corporate governance to be successfully installed governance mechanism. He continued and argued that internal audit is a function which through interaction with other control mechanisms of bodies offer a sound basis for a code of corporate governance. Regoliosi and Deri, (2012) argued it an intangible asset because it provides value to overall control and governance mechanism of an organization. The study of Paape et al. (2003) provides some indicative results about the perceptions of auditors concerning the relationship between corporate governance and internal audit. In this study, it is stated that 40% of the respondents believe that one of the most important factors in implementing internal audit is corporate governance. According to above research, 79% believes that changes in corporate governance will redefine the role and the responsibilities of the internal audit while 93% believe that one of the most important objectives of internal audit is the harmonization with the company’s policies rules and regulations.

Previous studies prove that audit quality as external company administration perceptive will improve organizations' performance (Bokhari & Khan, 2013). Auditors' obligations amplify well past the essential identification of highly contrasting GAAP infringement, to giving confirmation of financial reportage quality. This obligation emerges from professional examining gauges that oblige auditors to contemplate the quality, not solely the agreeableness of the client's financial reporting Statement of Accounting Standard (SAS 90). It is more mirrored within the audit assessment, which provides certification that the financial statements area unit properly exhibited as per GAAP, since cheap presentation needs a dependable illustration of the company's basic financial aspects Financial Accounting Standard Board. The auditor's wide charge to contemplate financial reporting quality is in addition certain with court selections that hold examiners subject to deluding cash connected proclamations, however, once those statements entirely adjust to accumulation.

The role of the audit committee in corporate governance is the subject of increasing public and regulatory interest. The audit committee is a sub-group of the full board. The audit committee gives the correspondence between the full board, insider auditor, outsider auditor, the executive officers, and fund executives. Peasnell et al. (2000) displayed a method of reasoning for the presence of the board audit committee that managers take the chance to act against shareholders' benefits when the agency cost increase. Contractual connections in the middle of shareholders and managers decrease agency costs. In any case, these agreements must be along these lines observed. The development of an audit committee emerges from the need to screen these agreements. Audit committee serve as trustees in a governance system decreases information asymmetry in the middle of internal and external and in this manner, mitigates agency issues. Beasley et al. (2009) likewise trusted that a successful audit committee has qualified individuals with authority and assets to ensure shareholders by safeguarding dependence on financial reporting, inward controls, and hazard management, however, its oversight part.

The independent of audit committees from the management play an important role in organizations because they have good reputations to transform transparency, support the board of directors, and prevent inadequate activity and oversight function of financial reporting. The language of independence has been termed as the degree to which an audit committee comprises of non-executive directors. According to established posits that an independent director is a non-executive director who is not a considerable shareholder of the organization that is one whose shareholding, straightforwardly or in a roundabout way, does not surpass 0.1% of the organization's paid up capital. The Independent non-executive directors on corporate groups identify with better checking of management choices and exercises by a corporate group. There is indirect confirmation supporting the thought that an autonomous non-executive audit committee can deflect financial reporting aggressiveness and misrepresentation. Audit advisory groups have no less than two means accessible to practice oversight of financial reporting, the external auditor, and the inside auditor capacity.

Peasnell et al. (2000) observed to reinforce the part of audit groups, as regulators of the financial reporting process, for New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations System (NASDAQ) also called

(NASD) firms. BRC (1999) is about the change of necessity of NYSE and NASD so as to give space for recorded organizations to have audit boards of trustees without executive's directors. Numerous other independent counseling bodies have planned rules with a recommendation to change both the audit committee and audit process. For instance, it was prescribed by Tread way Commission that: the audit board individuals from all public sectors ought to be made out of exclusively autonomous executives. The committee of the audit should be free so as to perform their task appropriately. Independent is pretty much as essential to the audit committee as it is imperative to the auditor. This will permit them to manage the organization's issues in a targeted way with no type of predisposition (i.e. bias). Audit committee autonomous is required to upgrade open trust in the corporate system with respect to their openness, competence in reporting and a consolation of adequate protections against false reporting and innovative accounting.

It is likewise foreseen that the audit group ought to cradle the relationship among governance organs inside the firm and outer organs Rezaee (2009) The freedom audit group advisory is vitally critical in upgrading the relationship between the outside auditor and management over the span of their obligations as well as in instances of quarrels between them (Arena et al., 2010). Keeping in mind the end goal to release their oversight capacities viably, it is imperative that the committee is independent non-executives of management. Expertise and experience of audit committee individuals is an essential part of audit advisory group viability in managing the evaluated financial articulations. Corporate governance procurements internationally require that the audit committee be made out of persons that have later and pertinent financial experience, in this manner inferring that they ought to have the capacity to, at any rate, read and comprehend the financial proclamations which incorporate the cash flow statement, notes to the accounts, income statement and the balance sheet. Further, a large portion of these procurements additionally requires that no less than one individual among the individuals ought to have recent significant financial capabilities.

3. METHODOLOGY

3.1 Data source

The collection of secondary data of 90 firms listed on the Iraqi stock Exchange was collected through the channel of annual reports of the year 2012, 2013, 2014, 2015 and 2016 and the annual reports were used to collect the data concerning the audit committee and big Four/Non-big Four. The independent and dependent variables are measured, classified, and quantified into a numerical type. Therefore, the association between the audit committee and audit quality is examined and assessed in a much applied statistical means from the data collected. The study is predicated on a panel data study.

3.2 Logit regression

Alghamdi (2001) claims that the regression method is broadly utilized for breaking down the relationship between dependent variable and one or more independent variables. Logistic regression, similar to least squares regression, is a measurement method that is utilized to investigate the relationship between a dependent variable and at least one independent variable. The regression techniques can be connected when the dependent variable is categorical. As a result, the remainder of this study discussion will focus on independent variables in this regression analysis. However, before then, the study carried out some diagnostic test to confirm the validity of the regression result. Based on the linear regression model the variance of each error term needs to be constant (homoscedasticity) likewise there should be the absence of correlation between the error terms (autocorrelation). Based on the Wooldridge test for autocorrelation the prob > F test is significant (0.000) suggesting the presence of autocorrelation. Similarly, the white test for homoscedasticity reveals a prob > chi2 that is significant at 0.0214 rejecting the null hypotheses of homoscedasticity and showing the presence of heteroscedasticity, which indicates that the error terms are not constant. On this note, the logit regression model was used considering the robust standard error as suggested by (Hoechle, 2007). According to Hoechle (2007) states that the robust standard error accounts for both the heteroscedasticity and autocorrelation issue. The results obtained from Logit regression are presented in table 4.3 below.

3.3 Model specification

To measure the impact of internal audit on corporate governance we have used the models, which are given below:

$$CGI_{it} = \alpha_0 + \alpha_1 NEDAC_{it} + \alpha_2 FENEDAC_{it} + \alpha_3 ACM_{it} + \alpha_4 ACS_{it} + \alpha_5 FSIZE_{it} + \alpha_6 LEV_{it} + \alpha_7 PROF_{it} + \varepsilon_{it}$$

Where, for each company (i) and each year (t); CGI: We adopt the approach of Al-Najjar (2015) for an SME CGI based on different corporate governance variables, namely, board size, board independence, board meetings, audit size, audit independence, audit meetings, existence of the remuneration committee, remuneration committee independence, existence of the nomination committee and nomination committee independence. The CGI is assessed from a scale of 0 to 10. If a firm in a year meets all of the components of the CGI then, it is assigned an index of 10=1; and for firms that have not met any of the criteria sustained in the index a value of 0 is assigned. The construction of the index is based on the recommendations of The Cadbury Report, NEDAC is the ratio of nonexecutive director member of the audit committee to a total member of audit committee, FENEDAC is a dummy variable which gives one if the non-executive director of the audit committee is accounting qualified and zero otherwise. ACM audit committee meeting which represents the frequency of audit committee meetings.

3.4. Correlation analysis

Table 1 Shows result on the bivariate statistical correlation among all the relevant variables. The results of the table show that all the variables are significantly correlated with each other.

Table1: Correlation Analysis

	CGI	AUDITQ	NEDAC	FENEDAC	ACM	SIZE	PROF	LEV
CGI	1							
ACS	0.4079*	1						
NEDAC	0.3764**	0.4354*	1					
FENEDAC	-0.2327	-0.2127	0.2906	1				
ACM	-0.1037**	0.2056**	0.2148*	-0.4328*	1			
FSIZE	-0.2433**	0.4313*	0.1711*	-0.2492*	0.1982	1		
PROF	0.4391***	0.2452**	-0.5741*	-0.2101*	0.2101	-0.1205	1	
LEV	0.2467***	0.3432*	-0.3461*	-0.1451*	0.3425**	-0.2453***	-0.2341**	1

*,**,*** denote statistical significance the 0.10, 0.05 and 0.01 level respectively

4. RESULTS AND DISCUSSION

The size of audit committee and firm size are only variables which in negative relation with corporate governance. Whereas all the other variables are in positive relation with corporate governance. The results are discussed in table 2.

Table 2: Logit Regression

Dependent Variable CGI	Coef	Robust Std. Error	Z	VIF
ACS	-0.7860	0.245	-2.75*	1.09
NEDAC	0.3240	0.146	1.87**	1.07
FENEDAC	0.2220	0.447	3.31	1.12
ACM	1.875	0.648	-2.71**	1.26
FSIZE	-1.123	0.321	1.28***	1.39
PROF	0.234	0.342	2.12	1.21
LEV	-0.029	0.008	2.45*	1.09
Cons	-0.769	-0.786	-0.534	
Number of Obs	605			
Prob>Chi2	0.000			
Pseudo R2	0.4321			
Mean Vf	1.30			

*,**,*** denote statistical significance the 0.10, 0.05 and 0.01 level respectively

The negative relation between audit committee size and corporate governance is consistent with predictions of agency theory that more member on the committee will add more time and resource cost, which ultimately increase. Therefore, it can be argued that for an effective code of corporate governance Iraqi firms should have small audit committees. The ratio of non-executive directors in the audit committee, which basically measures the independence of the audit committee is in positive relation. The results indicate that an independent audit committee strengthening the code of corporate governance. The results are again consistent with the proposition of agency theory that independent board by applying proper check and balance reduces agency cost. The financial qualification of the independent director is another most important factor which affects the corporate governance practices of any firm. In the current analysis the relationship between the financial expertise of independent directors and corporate governance practices and principal of Iraqi firms is positive. The results indicate that along with independence its mandatory to have qualified person on a board committee. Similarly, the frequency of audit committee also appears in a positive relation with corporate governance practices for the sample of Iraqi firms. Again, these findings are consistent with the propositions of agency theory. Meanwhile, they also provide support with a resource-based view which argued that committee with competent independent directors which held meeting frequently strengthen the corporate governance mechanisms of any firm.

5. CONCLUSION

The current study was carried out explore the role of internal audit in activating the principals of corporate governance. The size of the committee, independence of committee member, the financial knowledge of independent members and the meeting frequency committee are used as proxies of internal audit quality. Whereas corporate governance is measured by corporate governance index developed by (Peasnell et al., 2000). The results of the study have provided support with the proposition of agency theory. The size of the audit committee and firm size are only variables which in negative relation to corporate governance. Whereas all the other variables which the independence of audit committee are, qualification if independent director in the audit committee and frequency of audit committee meetings are in positive relation to corporate governance. The results indicate that along with independence it is mandatory to have qualified person on a board committee. Similarly, the frequency of audit committee also appears in a positive relationship with corporate governance practices for the sample of Iraqi firms. Again, these findings are consistent with the propositions of agency theory. Meanwhile, they also provide support with a resource-based view which argued that committee with competent independent directors which held meeting frequently strengthen the corporate governance mechanisms of any firm.

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