

RELATIONSHIP OF INTERNAL AUDIT QUALITY AND CORPORATE GOVERNANCE MEASURES OF MULTINATIONAL CORPORATIONS (MNCS) OF PAKISTAN

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Abstract. *The internal audit is a primitive element for good corporate governance. This need has been largely felt in the developing countries to enhance and promote the corporate governance mechanism. This research evaluates the implication of internal audit of Multinational Corporations (MNCs) of Pakistan on corporate governance's quality. The outcomes of this research reveal significance of internal audit role in corporate governance of MNCs. The significance of audit committee and management in this aspect is predominant. Similarly the results also show the vitality of corporate governance in terms of quality is significant when there is independent audit department with requisite expertise of auditing. However, the reliability of internal audit is primarily determines the characteristics of management of corporate governance. Contrary to this, the implication of internal audit is insignificant on the external audit workers as well as the board of directors of MNCs in Pakistan.*

Key words: Corporate Governance, Internal Audit, MNCS, Pakistan.

Introduction

This study adds on value in producing a greater understanding into the implication of quality of internal audit and corporate/organizational governance mechanisms in MNCs working in Pakistan. The significance and efficacy of these results is valuable for the regulators, investors, and overall stakeholders for their requisite concerns in terms of value creation and performance.

The purpose of this paper is to estimate the implication of good internal audit practices on the organizational/corporate governing practices in MNCs of Pakistan. The relationship in terms of quality of internal audit performance and its due implications on organizational/corporate governance has been redefined in larger spectrum (Abdullah, 2014; Sarens, et al., 2012).

The importance of sound internal audit performance and the up-to-mark mechanisms of organizational/corporal governance have becoming very imperative after the world financial crisis of 2007-09 (Mohamad & Sori, 2011).

Literature Review

In the recent two decades, the importance of corporate governance has gained a tremendous attention because of various notorious financial scandals happened. The critical aspect related to the smooth functioning of corporate governing is the quality of internal audit of the firms. Due to financial turmoil and scandals, that hampers many businesses across the globe from smooth working which resultant in the economic activity deterioration which caused the higher inflation and lowering the purchasing power of the incumbents (Ibrahim, 2011).

The Securities Exchange Commission of Pakistan has initiated a strong and bold step for the codes of corporate governance in 2002. These codes are better aligned with the international codes, standards and guidelines for effectively protecting the incumbent stakeholders. The essence of deploying good corporate governance is to attain the sustainable economic development by increasing and invigorating the requisite resources of the corporations for better financial performance and attaining maximization of shareholders' value at the end. Good corporate governance mitigates the clashes of interests and aligns the interests of all stakeholders in the better prospects of the corporations on win-win phenomena. Congenial corporate governance reduces the clashes of interests between shareholders and the management (Jensen & Meckling, 1976). The effective corporate governance places high value and satisfaction for both entities by protecting their interest and attaining the overall goal of the corporation with efficiency.

Internal audit function

Internal audit is defined by Reding, et al. (2013) is a unit that provide a thorough insights to the management and boards in terms of internal control, risk management, governance parameters for the reasons to improve upon the governance aspects, operational efficacies (reporting and compliance as per standards) to cope up the strategic goals and objectives. The internal audit function is having significantly positive association with organizational/corporate governance mechanisms for improving upon the strategies for risk management by augmenting the internal control, enabling management for taking corrective measures when needed and catering all inputs of audit committee for reaping more sophisticated outcome for the achievement of the organizational objectives (Sarens, et al., 2012).

The internal audit provides with a deep insight of understanding the imminent risks with appropriate suggestions and recommendations to hedge and mitigate it (Jie, 2012). Internal control is imperative for the system in terms of safeguarding organizational assets and ensuring all the activities of the businesses according to the incumbent organizational policies and rules. The domain of internal control can be versatile i.e. financial as well as non-financial aspects of the organization for its management and control. The internal audit function is responsible for coping up with the adequate control of the organization for ensuring smooth running of it (Boghean & Boghean, 2013).

According to El-Kassar, et al. (2014) determined that the internal audit functions critically impacting the organizational/corporate governance specifically for audit committee and administration. Furthermore, the independence of audit department with its due expertise is having far reaching positive implications on the mechanisms of good corporate governance. Besides, it is also impacting the characteristics of management in general.

The internal audit is highly imperative for effective corporate/organizational governing practices in any business environment for effectively coping up the objectives of the management for enhancing value creation of stockholders. This is based on the notion of effectively protecting their rights from any undue influences (Mihiotis, & Konidaris, 2007). The importance of internal audit is highly recognized throughout the whole globe after promulgation of Sarbanes-Oxley Act of 2003. The core theme was to protect the incumbent shareholders by protecting from unwanted anomalies happening in the businesses with the perspective of adding more value in the requisite organization (D'Silva & Ridley, 2007).

Organizational/corporate governance

The objectives of any organization can't be effectively achieved without having efficient organizational/corporate governance in place. The most imperative role resides on the shoulders on board of directors for effectively deploying the corporate governance mechanisms in true spirits. Their presence necessitates that all the departments should congruently work for catering the envisaged vision and objective for achieving higher value creation efficiently. On the other hand, the external auditors provide the unbiased and impartial reports regarding the working activities of the internal governance structure for their boards and management's role played for the creation and sustainability of value for the shareholders (Saltaji, 2013).

The essence of effective corporate governance has been initiated and coined by Organization for Economic Cooperation & Development-OECD in 1999 as the mechanisms and system through which corporations would be controlled and run effectively for the better interest of the organization and stakeholders. This has been validated by Kirkpatrick (2009). Similarly, Cadbury (2010) defined the organizational/corporate governance as it keeps balance between social and economic goals of the organization.

The Method Design

This research utilizes comprehensive and objective questionnaire to determine and estimate the implication of internal audit functionality and its due implications on corporate/organizational governance parameters and practices deployed in MNCs of Pakistan. The incumbent questionnaire entails questions regarding various aspects

related to the mechanisms of corporate/organizational governance: For instance, Top Management; Board of Director; audit committee; external and internal audit. The incumbent questionnaires were distributed to the internal employees of the organizations i.e. heads/executives of internal audit; Heads of audit committee; and chief executive officers for knowing the importance of internal audit in shaping effective mechanism. For reliability and accuracy, the survey results have been measured.

Methodology

An objective questionnaire has been designed from the previous questionnaires of King 2 and 3 to determine relationship between the organizational/corporate governance mechanisms in association to top management; board of directors; audit committee; the quality work of internal as well as external auditors.

This study is utilizing the suitable sample of 100 questionnaires distributed to the top executives (Chief Executive Officers-CEOs); Heads of audit committee; and heads of internal audit units. The completed questionnaires returned were 72. Each questionnaire comprised a total of 34 related queries about the internal audit and organizational/corporate governance mechanism in MNCs of Pakistan (a detailed questionnaire can be found as Appendix-1 at the end).

- The first section comprising questions related to demographics
- The second section comprising questions related to internal audit function quality
- The third section comprising questions related to examine the requirements and features of corporate/organizational governance.

This study utilizes 5 points Likert scale for measurement. The scores obtained are averaged of organizational/corporate governance quality mechanisms (CGQ) and internal audit quality (IAQ). Besides the 03 sub-calculated internal audit measures in terms of quality are determined as:

- The freedom and independence of internal audit determined by IAQ-1 (IAF: 01 to 04).
- The trustworthiness of internal audit practices/functions determined by IAQ-2 (IAF: 05 to 09).
- The testimonials of audit staff (internal) determined by IAQ-3 (IAF: 10 to 14)

Similarly the incumbent 4 parameters of organizational/corporate governance quality recognized are given as follow:

- The efficacy of the boards of directors (BODs) determined by CGQ-1 (CG: 01 to 04).
- The efficacy of the committee (audit) determined by CGQ-22 (CG: 05 to 10).

- The efficacy of administration/management determined by CGQ-3 (CG: 11 to 12).
- The efficacy of external audit role determined by CGQ-4 (CG: 13 to 14).

The Results

Statistical analysis

This part comprises the statistical analysis of data gathered from the respondents cater descriptive statistics, correlation and regression analysis. The data from the requisite respondents are analyzed through descriptive statistics for larger understanding of the incumbent association. Besides, the gathered data are analyzed through correlation and regression for understanding the imperativeness of the given parameters. The data are analyzed for its reliability. Given the value of Cronbach alpha, the various aspects relevant to organizational/corporate governance are obtained in terms of quality, which are: for board of directors' questions it was 0.821; for audit committee it was 0.832; for management it was 0.758 and for external audit, it was 0.768. Similarly for internal audit, the Cronbach alpha values were as follow: independence related questions cater 0.835; reliability related questions cater 0.864; and education related questions of internal audit workers, it was 0.895. Here it is safe to summarize the outcome achieved through the incumbent objective questionnaires is highly valid and reliable for thorough and complete analysis.

The outcomes in terms of demographic can be précised as follow: 82 percent of the questionnaire respondents were male and 18 percent were female; 67 percent were in the age bracket of 30 to 40 years -11.80 percent of less than 30, and 20.60 percent were over more than 40 years of age; Master degree holders stood the highest as 60.30 percent, 25 percent were having bachelor degrees, 8.8 percent were having high school diploma, and 5.90 percent were having doctorate degrees; 47 percent were having a CPA qualification, while 7.4 percent were having CFA, and 6 percent were having CIA; 46 percent were having specialization in auditing and accounting, 44 percent in business administrative studies, and 10 percent in finance; in terms of experiences, 50 percent were having minimum of 10 years of experience in the same field while 44.5 percent were having work experience in between 5-10 years.

The above mentioned facts and figures in terms of qualifications, knowledge, experience and maturity of respondents enhances the reliability of the information with trustworthy conclusion at the end.

The descriptive statistics regarding the quality of internal audit are scored against IAQ, IAQ-1, IAQ-2, and IAQ-3. The mean scores were varying in between 4.26 and 4.45. Based on compiling these results against 5 point Likert scale approach, it shows that all the multinational corporations working in Pakistan are effectively complying up with all essential criteria and requirements to cope up with high quality of independence, skillful internal audit workers and reliability in all parameters.

On the other side, average for corporate/organizational governance ratings CGQ, CGQ-1, CGQ-2, CGQ-3, and CGQ-4 put together to be in the range of 4.21 and 4.74.

Therefore, all such corporations have excellent corporate/organizational governance efficiency in conditions of well-governing boards of directors (BODs), well-working audit committees, efficient control of management/admiration, and good worth of external audit workers.

The Discussion

Correlation analysis

Having obtained the critical value of $\pm 0.240^*$ at significance level of 5% and critical value of $\pm 0.311^{**}$ at a significant level of 1%, the following outcomes can be established:

At 5% degree of significance, there is no connection and correlation exists between 3 internal Audit's scores i.e. IAQ-1, IAQ-2, and IAQ-3 offered by correlation coefficient with lower level. This facilitates the determination of the given ratings for the implication of internal audit on organizational/corporate governance of MNCs working in Pakistan.

A significant correlation occurs between corporate governance quality and internal audit quality, indicating the largely quality of internal audit and corporate governance. Corporate governance quality has been found to be having significantly positive correlation with the freedom of internal audit IAQ-1 at 1% and with the qualifications and knowledge of the internal auditors represented through IAQ-3 at 5% significance level. While the internal audit reliability represented through IAQ-2 does not show correlation with corporate governance quality represented through CGQ. Thus it can safe to conclude from these findings that independence and level of expertise of internal audit workers significantly effecting the corporate governance quality.

Considering and evaluating the rest of the corporate governance sub-measures, it showed no correlation existed between the board quality represented through CGQ-1 and the quality of external auditors represented through CGQ-4 with any of the internal audit scorings. This showed that the internal audit work does not have any impact on the quality of the board and the functionality of external auditors.

The quality of the audit committee represented through CGQ-2 has shown with significant positive correlation with internal audit scorings of IAQ-1 and IAQ-3 at 1% significance level but its opposite with the reliability measures at the same significance level. This shows that internal audit impact the audit committee in terms of effectiveness and functionality while it does not have any impact on reliability measures.

The quality of management which is represented through CGQ-3 shows significant correlation with internal audit at 1% level of significance. That means that internal audit practices has a significant impact on management/adminstration in terms of quality.

Table 1 *Correlation Matrix*

	<i>IAQ</i>	<i>IAQ1</i>	<i>IAQ2</i>	<i>IAQ3</i>
CGQ	0.311**	0.359**	0.013	0.287*
CGQ1	-0.03	0.100	-0.09	-0.09
CGQ2	0.425**	0.444**	0.099	0.389**
CGQ3	0.487**	0.347**	0.249*	0.379**
CGQ4	-0.156	-0.09	-0.16	-0.09

Regression analysis

Table-2 shows the regression analysis which are as follow: The quality of board and external auditors represented through CGQ-1 and CGQ-4 respectively, both dependent variables, has shown no significant effect. This outcome is in line with the already availed results of correlation coefficients. While the quality of internal audit has shown positive implication in terms of board independence and qualification of audit team which could influence positively the audit committee governance represented through CGQ-2.

At the end the regression analysis having CGQ-3 (as dependent variable) is indicating that the internal audit quality clearly impacting the audit committee domination for its individuality at 1% degree of significance. While the reliability of internal audit workers along with qualifications are showing positive significant result at 5% level of significance.

Table 2 *Regression Model*

<i>Variable</i>		<i>Intercep</i>	<i>IAQ1</i>	<i>IAQ2</i>	<i>IAQ3</i>	<i>Overall</i>
CGQ1	Coefficients	4.1179	0.1127	-0.0239	-0.040	
	p-value	0.0000	0.4047	0.8276	0.6557	0.8189
CGQ2	Coefficients	0.0649	0.5967	0.029	0.3389	
	p-value	0.9580	0.0015	0.8229	0.0098	0.0001
CGQ3	Coefficients	0.3116	0.4809	0.2986	0.2907	
	p-value	0.7767	0.006	0.0518	0.0276	0.0002
CGQ4	Coefficients	6.1789	-0.1656	-0.3120	-0.008	
	p-value	0.00012	0.5817	0.1417	0.9649	0.4679

Conclusion

In the recent decade there has been an imperative focusing on corporate governance practices specifically how to improve upon its quality. In this connection, the internal audit is the main element that determines the effective corporate governance in firms. This study evaluated the impact of internal audit quality in

stimulating and promoting the corporate governance measures related to the multinational corporations working in Pakistan. This study analyzed and investigated the association and relationship between quality of internal audit, reliability, independence, qualifications and expertise of team working for the firms and the effectiveness of corporate governance in light of board of directors, management, committee for audit and external auditors.

The outcomes show substantial association and relationship between the characteristics of internal audit quality and corporate governance. It has been evident that the audit committee and management have been largely affected due to internal audit quality. Furthermore, it has been revealed that keeping high grade of independence and audit department expertise, could have significant implication on the corporate governance quality. Besides, the internal audit reliability has shown significant implication on management. Contrary to that the external auditors and the board of directors are relatively less impacted by the internal audit.

Recommendations

In light of the above results, it is safe to recommend that organizational/corporate governance in light of audit committee, the executive of internal auditors should properly maintain accurate, in-time, reliable and independent reporting to the head of audit committee and to the top executive of the organization i.e. CEO for larger disclosures and compliance as per standards. Apart from that the audit committees are supposed to develop the annual financial planning couple with budgeting independently. Such development on the part of audit committee may not bear any influence from the management. This notion of carrying along with the standards and governmental regulations would eventually be protecting the interest of the stakeholders in larger spectrum which would contribute to the smooth functioning of management.

To cater and enhance the measures of corporate governance, it is imperative to have a team of internal audit well equipped with appropriate qualifications, skills, experiences and training to comply audit according to the given charters and standards independently.

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Appendix-1: Questionnaire

The first section comprising six questions related to demographic.

01	Level of qualifications (High school, Bachelor, Masters, Doctorate)
02	Specialization (banking, business administration, accounting & auditing ,other)
03	Experience (<5 , 5-10 , >10)
04	Specialized certifications/qualifications (CIA, CPA, CFA, no certification, other)
05	Age bracket (<30, 30-40, >40)
06	Sex (male, female)

The 2nd section comprising fourteen questions related to internal audit function quality

01	Internal audit function's head has a functional and effective reporting line to the chairman of audit committee.
02	The internal audit head has managerial reporting link to the chief executive officer (CEO).
03	The plan of internal audit and budget are prepared without taking into account for the senior management recommendations.
04	The head of internal audit sees confidentially with the board of directors or Head of audit committee with-out administration presence.
05	The internal audit department has formal and official strategy in the shape of audit contract.
06	Does the internal audit comply the standards set by the government?
07	The internal audit workers work as per the guidelines and formulated procedures and techniques developed by the board.
08	The practice of in-time and real time reporting from internal auditors are intact for avoiding any unlawful and unwilling functionality to the requisite top management.
09	To cater higher quality of job and accuracy in formulating audit report, the internal auditors are having privilege to conveniently accessibility to information and the incumbent people.
10	Sufficient training and development programs are carried for enhancing the capabilities of internal auditors.
11	The quality of the job is intact due to requisite skills and expertise from the internal auditors.
12	Professional qualifications/certifications are acquired by the majority of the internal audit workers.
13	The head of internal audit unit is having the requisite skills and experiences for doing the due tasks effectively.
14	The head of internal audit unit is normally coming from a versatile business background rather than effectively from the background of appropriate and professional audit's prospective.

The 3rd section comprising fourteen questions related to examine the requirements and features of corporate/organizational governance.

01	The composition of board is fair and independent.
02	The board members are having the requisite skills, expertise and related information.
03	The member of the board is entertaining sufficient timing for moving along with their duties effectively.
04	Each year, there used to hold at-least 4 meetings of the board.
05	The composition of boards' member is fairly independent.
06	At-least one of the board's member is having good knowledge of finance.
07	The plans and key changes of the internal auditors are supported by the audit committee.
08	The internal audit reports are analyzed by the audit committee.
09	The work responsibility carried out by the audit committee in terms of appraisal of the performance and even termination of the head of internal audit is effectively tackled by audit committee.
10	The working relationship between the audit committee and internal audit workers are congenial.
11	The internal controlling parameters given in the policy framework are in place.
12	The controlling mechanisms given in the policy books of the organization are effectively operational.
13	External auditors are intact in one of the big 5 accounting firms.
14	The internal and external auditors are synchronized in terms of working of the audit of the incumbent organization.