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Internal Auditing and Financial Performance of Tehran Stock Exchange listed companies

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ABSTRACT

The purpose of this paper is to assess the internal auditing practices on the financial performance of Tehran Stock Exchangelisted companies and to consider the effect of a contextual factor-Political influence on this relationship. While much empirical works have given diverse reasons for the poor financial performance of TSEs, research evidence of the impact of internal auditing practices on the financial performance of TSEs in the Iran context is scanty. The study found no strong association between internal auditing practices and financial performance of TSEs and those political influences do not significantly impact this relationship. The weak association between internal auditing practice and financial performances is attributed to these enterprises' inadequacy and poor implementation of internal auditing practices. Where internal auditing is de-emphasized it cannot impact positively on performance.

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Introduction

State participation in economic activity is a worldwide phenomenon. In Iran, the government at all levels is active participants in economic activities such as being involved in business activities through the floating of Stock exchange Companies (TSEs). TSEs in Iran are expected to operate like their private counterparts; obeying the rule of incorporation according to the company laws of Iran and making enough business profits to survive business competitions (Fubara 1982). However, quite a number of these companies are "sick" and some are in the process of becoming so. Concerned about the negative financial performance of majority of TSEs in Iran, Fubara (1982) examined the reasons for the prolonged abysmal TSEs' financial performance and established that TSEs perform very poorly in terms of profitability criteria set for them. He attributed the poor performance to inept management, insufficient funds, paucity of technology and incongruent management – organization-government objectives.

The unsatisfactory performance of TSEs in Iran had been blamed on diverse reasons. Makoju (1991) had blamed the poor performance state to the bureaucratic red-tapism and lethargy of the civil service which is still intact in the management and operations of such companies. The Federal Ministry of Finance Incorporated (2006) had identified high incidence of fraud, government's employment of staff based on political connections rather than on ability to perform, parliamentary control and financial indiscipline as causes of poor performance. Dogo (1990) has alleged that the accounting systems of TSEs in Iran do not seem to guarantee proper and up to-date financial records thus making auditing difficult, if not impossible.

A BPE report (2003) states that only 160 of the 590 federal stock exchange public enterprises were involved in economic activities and that their rate of return was less than 0.5 percent. A company's accounting control practices (such as internal auditing) is widely believed to be crucial to the success of an

enterprise as it acts as a powerful brake on the possible deviations from the predetermined objectives and policies. This means that an organization that put in place an appropriate and adequate system of accounting controls is likely to perform better (in financial terms) than those that do not. As Okezie (2004) puts it, "an enterprise's internal audit function can significantly affect the operations of the enterprise and may have an impact on the ability of the entity to remain a going-concern. Conrad (2003) had portrayed Enron's demise as the consequence of a "few unethical 'rogues' or 'bad eggs' acting in the absence of any control". Thus inadequate control systems may negatively affect an organization's success. According to Hermanson and Rittenberg (2003) the existence of an effective internal audit function is associated with superior organizational performance. Although prior research (for example, Mak, 1989 and Simons, 1987) suggest a link between accounting control practices and financial performance, majority of prior studies had concentrated mostly on the budgeting aspect of accounting controls. This aside, the available studies so far had dealt exclusively with large privately-owned companies especially in the advanced countries. Little is known, at present, about the influences of internal auditing practices on the financial performance of TSEs in Iran. It was in an attempt to fill this gap that we set out to assess empirically the impact of internal auditing practices on the financial performance of TSEs in Iran and to consider the effect of political interferences on this relationship.

Research Background

Internal audit is a long-standing function and an effective tool of management in many organizations. It has been a recognized component of organizations in both the public and private sectors and in most industries for many years. Internal auditing is often seen as an overall monitoring activity with responsibility to management for assessing the effectiveness of control procedures which are the responsibility of other functional managers. The internal audit function is not limited to the operation of any particular function within an organization.

Rather, it is all-embracing and accordingly is structured in the organization as a separate entity responsible only to a high level of management. As Okezie(2004) puts it, the main objective of internal auditing is "to assist management in the effective discharge of their responsibilities by furnishing them with analysis, appraisal, recommendations and pertinent comments concerning the activities reviewed". Internal auditing which is often seen as constituting a large and significant aspect of an organization's financial control system is a vehicle to success and survival. According to Rittenberg and Schwieger (1997) "internal auditing is taking on increased importance in many of today's global organizations by assisting management in evaluating controls and operations and thereby providing an Important element of global control". Venables and Impey (1991) also recognized the control role of internal auditing when they stated: It is generally recognized that the proper organization, staffing and methodology of internal audit presents the board with the best means of focusing on its obligation to ensure proper controls in the business. However, the need for an internal audit function will vary depending on company specific factors including the scale, diversity and complexity of the company's activities and the number of employees as well as cost/benefit considerations (ICAEW, 1999). Moreover, Venables and Impey (1991) had argued that for an internal audit function to be effective to enable an organization realize its full benefits, the function must have clearly defined objectives, authority, independence and appropriate resources. Performance is a term that is often discussed but rarely defined. Indeed, some writers see the term as highly ambiguous capable of no simple definition (Emmanuel et al 1990; Otley, 1999). Earlier, Emmanuel et al (1990) had observed that the frequent use of the term suggests that it may more often be used to avoid precise definition of what is meant. According to Euske (1984), the most common definition of the term can be "accomplishments of the organization". Thus, an organization that is performing well is one that is successfully achieving its goals and is effectively executing suitable strategies. TSEs are the creations of the government with government as shareholders holding these shares in trust for the general taxpaying public. Although, it is true that TSEs may be evaluated in the same way like their private counterparts (Mazzolini, 1979), it is equally important to remember that these companies were established also to promote government's socioeconomic policies. Viewing it from this dimension, some scholars (for example, Lal, 1980) have argued that the evaluation of government investment should employ social/cost benefit analysis. In this circumstance, the performance of TSEs would be measured in terms such as employment which has been provided, assistance given in training manpower, standards of living improved and other welfare matters. These, no doubt, are important matters. But there is another side to this argument. Fubara (1982) had established that the major objective of TSEs in Iran was "to make profit in order to remain in business". That means all other objectives such as providing employment and giving assistance to the community are regarded as secondary. If profit-making is the major objective of TSEs in Iran it follows that these companies should be evaluated using profitability criteria employed by privately-owned companies. Moreover, prior studies of TSEs' performance, for example, Prasad and Rao(1989), Fubara (1982), Hope (1982) and Rosete (1981) all employed profitability criteria in evaluating performance. Mazzolini (1979) had noted that economic results or performance of TSEs may be measured using their profitability: return on

investment; sales growth and the balance sheet situation (say, liquidity situation). On the basis of these clarifications, the present study evaluates TSEs on the basis of their financial performance. Financial measures are typically derived from or directly related to chart of accounts and found in a company's profit and loss statement or balance sheet. According to Emmanuel et al (1990), financial performance measures serve two purposes: they measure the return given to the providers of finance (such as shareholders) and they present an assessment of the overall capabilities of the organization as a whole. The performance indices - profits, return on investment and return on equity - were, thus, adopted in this study. Most internal audit professionals argue that an effective internal audit function correlates with improved financial performance. According to Bejide (2006), an effective internal audit service can, in particular, help reduce overhead, identify ways to improve efficiency and maximize exposure to possible losses from inadequately safeguarded company assets all of which can have a significant effect on the bottom line. Similarly, Venables and Impey (1991) had stated that internal audit is an "invaluable tool of management for improving performance". Fadzil et al (2005) had also noted that internal auditors help run a company more efficiently and effectively to increase shareholders' value". And Hermanson and Rittenberg (2003) had argued that the existence of an effective internal audit function is associated with superior organizational performance. At the empirical level, a survey conducted by KPMG (1999) found that the internal audit function in organizations where it exists, contributes substantially to performance improvement and assist in identifying profit evidence in corporate disasters, particularly financial fraud consistently documents an association between weak governance (e.g. less independent boards or the absence of an internal audit function) and the incidence of problems (e.g. Dechow, et al 1996; Beasley, 1996; Beasley et al 2000; Abbott et al 2000). Thus, internal audit by acting as a watchdog could save the organization from malpractices and irregularities thus enabling the organization to achieve its objectives of ensuring high level of productivity and profit. Greenlay and Foxall (1997) note that although studies have found an association between accounting control systems and performance theory also predicts that these associations will be influenced by external environmental influences. Thus even though TSEs are intended to be insulated from politics they are however linked with politics through the powers vested in the respective Ministers, Commissioners or Deputy Governors. These powers, according to Akinsanya (1992), include power to appoint the Chairmen, Chief Executive Officers and members of the boards as well as power to offer advice or suggestions or make requests. Akinsanya (1992) contends that board members of TSEs in Iran are appointed not because of any requisite experience but largely because of political reliability. Hence, board members not only interfere with corporate management but also use their positions to promote the interests of their favourites with dire consequences for the enterprise's performance.

These considerations lead us to the following hypotheses:

Ho1: There is no significant relationship between the existence of an internal audit function and profit level in Tehran Stock Exchange listed companies.

Ho2: There is no significant relationship between the existence of an internal audit function and returns on investment in Tehran Stock Exchange listed companies.

Ho3: There is no significant relationship between the existence of an internal audit function and levels of return on equity in Tehran Stock Exchange listed companies.

Ho4: Political influences on the management of a Tehran Stock Exchange listed companies do not significantly influence the internal auditing practices/ performance relationship.

Research Data and Methodology

The study of non-observable events such as opinions, attitudes preferences or dispositions (Soyombo, 2002, Fubara and Mguni, 1995). Specifically, the study was a correlation, non-contrived and cross-sectional survey having individuals (officials of Tehran Stock Exchange listed companies) as unit of analysis. The design was such as to discover vital predictive relationship and degrees of association among variables.

Results

It is widely believed that internal auditing, where it exists, contributes to improved financial performance of the organization. According to Bejide (2006) "an effective internal audit service can, in particular, help reduce overhead, identify ways to improve efficiency and maximize exposure to possible losses from inadequately safeguarded company assets all of which can have a significant effect on the bottom-line". Venables and Impey (1991) opined that internal audit is an "invaluable tool of management for improving performance". To Hermanson and Rittenberg (2003) the existence of an effective internal audit function is associated with superior organizational performance. Prasad and Rao (1989) expressed similar sentiments when they observed that the internal auditor by acting as a watchdog saves the organization from malpractices and irregularities thus enabling the organization to achieve its objectives of ensuring high level of productivity and profit. Our finding in this study, however, contradicts the above positions. We found that there was no significant relationship between the existence of an internal audit function and financial performance of TSEs. That is, internal auditing, where it exists, does not influence the profit levels, return on investment and return on equity of TSEs. This finding is at odds with that of KPMG (1999) which identified a positive association between an internal audit function and financial performance. In a survey of some 201 senior company executives in the United States, the KPMG study found that the internal audit function in organizations, where it exists, contributes substantially to performance improvement and assist in identifying profit improvement opportunities. Our findings in this study also contradict that of Fadzil, et al (2005) which found that internal auditors assist in running a company more efficiently and effectively to increase shareholders' value. On the other hand, the findings are similar to that of Griffiths (1999) which found no relationship between internal audits and performance. That study found widespread "lukewarm" or negative attitudes to internal audit (in the privately).

The absence of a significant relationship found between internal auditing practices and financial performance may be attributed to the size of TSEs involved in this survey. Internal auditing is believed to be associated more with large than with small companies. Prior studies (for example, Carcello et al 2005; Stewart and Kent, 2006) found a strong association between internal audit and the size of the firm. These findings suggest that smaller firms do not regard internal audit as cost effective. In the present study, a majority of the TSEs fall within the "small" category, (using the classification criteria adopted earlier stated in the methodology section). Even among some of the large ones having internal audit departments, the

actual practices suggest a possible under emphasis on internal auditing. Therefore, the seemingly de-emphasis on internal auditing by the majority small TSEs may have contributed to the absence of a significant relationship between internal auditing practices and financial performance. Where internal auditing is deemphasized, clearly it cannot impact positively on performance. It is a matter of concern that some of the TSEs do not have internal audit Departments. Interestingly, however, some of the companies (qualifying as large going by this study's criteria) had been making substantial profits for so many years now. This goes to affirm the fact that superior financial performance may not come about just from an internal audit function. Even in those cases where an internal audit department (or unit) exists, the departments were functioning with skeleton staff not adequate in relation to the size of the company. Majority of the companies have internal audit staff numbering between one and five. None has more than ten irrespective of the size. A majority of the internal audit Departments are headed by college graduates with years of experience or by graduate accountants. A negligible few are under the headship of a chief internal auditor with professional accountancy qualification. The internal audit Departments of the surveyed enterprises could not have been effective as internal auditors in these companies lacked professional independence in the discharge of their duties. In order to serve a constructive purpose internal audit judgments have to be unbiased and therefore can only be made by taking an objective view from an impartial viewpoint. As we saw in Table 3, the internal audit Departments of these companies, where they exist, lacked the freedom to plan and carry out the work thus limiting the scope of the audit conducted by the Department. They also lacked the freedom of access to the highest level of management and to determine the appointment or removal, promotion and remuneration of internal audit staff all of which make for internal auditor's independence. In these situations, the watchdog's job of saving the undertaking from malpractices and irregularities which in turn leads to improved performance is greatly undermined. Moreover, where company management fails or it is reluctant to take actions on internal audit reports and recommendations, internal auditing suffers. This is the case of our surveyed companies as we saw in results. The above discussion leads to a very significant conclusion: the internal audit function, where it exists, does not significantly influence

Financial performance of a TSEs. The absence of a relationship may be attributed to a possible under emphasis on internal auditing by TSEs. Where internal auditing is not accorded any serious attention, clearly it cannot impact positively on financial performance. Financial performance of a TSE may improve not as a result of just an internal audit function (especially when proper attention is not accorded it) but also from some other variables. The foregoing clearly shows that the functioning of the internal audit system in the surveyed TSEs had not been effective. Had it been effective, it would have benefited the enterprises in several ways by plugging out loopholes present in their various activities thereby improving financial performance.

Political influence (which we used in this study as synonymous with the external environment) was hypothesized to have a moderating effect on the internal audit practices/performance relationship. Political influence was measured by government's appointment of Board members. Prasad and Rao (1989) had alleged that political influence is generally seen in the matter of appointment of Board members

and other executives to TSEs. The variable -political influence - was found to have no moderating effect on the relationship between internal auditing practices and financial performance of TSEs. This finding is consistent with William's (2005) study of small and medium sized Singaporean firms which found no direct relationship between accounting control practices and the overall firm performance when the environmental influences of uncertainty was added. Government's appointment of Board members which may include politicians may not after all be bad per se so long as it is done on merit and not on political grounds. Akinsanya (1992) had observed that in the United Kingdom, the Minister is required to make appointments from among persons "appearing to him to be qualified as having had experience of and having shown capacity in industrial, commercial or financial matters, applied science and administration or the organization of workers". In concluding our discussion, it may be necessary to point out that the absence of a significant relationship between internal auditing practices and the measure of financial performance adopted could mean that internal auditing practices have become a necessary but not sufficient condition for financial performance in TSEs in Iran.

Recommendations

From our discussion of findings, we can conclude that the present study provides some evidence on the performance consequences of internal auditing practices in TSEs in Iran. Specifically, the internal audit function, where it exists, in a TSE does not significantly influence financial performance and that political interference by way of government's appointment of board members does not significantly impact these enterprises' financial performance. The absence of a relationship arose from possible under emphasis on internal auditing by these enterprises. Where the internal audit function is de-emphasized (as the present study shows), clearly, it cannot impact positively on financial performance. Consequently, we strongly recommend the creation of an Internal Audit Department in those enterprises where there is none. Existing Departments then should be strengthened by according them the necessary professional independence and employing adequate number of experienced and qualified staff to enable the Department extends coverage of the audit to all 15 significant activities of these enterprises. Had that function been effective, it would have benefited the enterprises in plugging out loopholes that may be present in the enterprises' activities with resultant positive effects on financial performance. Although, the present study offered some contributions to our understanding of the relationship between internal auditing practices and corporate financial performance, future research should incorporate non-financial measures such as quality, employee satisfaction in addition to financial measures in order to further enrich our understanding of the internal auditing/performance relationship. It is also suggested that future research should examine companies with "mixed ownership", that is, those partly owned by government and partly by private investors so as to see what impact the elements of private and government ownership together would have in an internal auditing practices/performance study.

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