

**PROMOTING GOOD CORPORATE GOVERNANCE AND BUSINESS  
SUSTAINABILITY THROUGH EFFECTIVE INTERNAL AUDIT  
FUNCTIONS—A STUDY ON LISTED HOTELS IN LEBANON**

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***Abstract:** Internal audit function is a compliance mechanism that promotes good corporate governance. Recent studies detected the need to improve corporate governance structures in developing countries. This study evaluates the effects of the internal audit function on the quality of corporate governance in the context of listed hotels in Lebanon. The results revealed that the effectiveness of internal audit functions significantly affect corporate governance, particularly in management aspects. Moreover, the results showed that maintaining a high level of independence in auditing system and professional competency and scope of wider audit work creates value addition for the hotel in promoting fairness, transparency, accountability, responsibility and as well as business sustainability. The result also indicates that the reliability of the internal audit functions is significantly influenced by the top-level management of the hotels.*

***Keywords:** Internal Audit Function, Corporate Governance, Independency, Business Sustainability.*

## **1. INTRODUCTION**

In the past 15 years, several triggering corporate events like the financial crisis, corporate scandals and failures have brought corporate governance issue in focus. If the government refuses to heed public opinion and limits the freedom of speech, there will be a crisis between the government and the people and the higher the level of corruption demonstrates accountability was not fully completed that reflects the high level of corruption is bad bureaucracy, which means also that the implementation of good governance is still far from expectations. That means no governance system, no matter how well designed, will fully prevent greedy, dishonest people from putting their personal interests ahead of the interests of the organizations they manage. However, certain steps can be taken to improve good governance and thereby reduce opportunities for accounting fraud and irregularities. Implementation of good governance in the field of financial management, one of which is through the imposition of an obligation of the head to the area to prepare the result of financial statements in according to accounting standards and other prevailed regulations to evaluate the report and the examiner expert opinion.

Internal audit is described by Reding et al. (2013) as a value proposition providing objective assurance to management on corporate governance, risk management and internal control put in place as well as giving insight (consulting services) to management on how to improve operational effectiveness and efficiency in order to achieve organization's goals and objectives (strategic, operations, reporting and compliance). On the other hand, external auditing is needed to provide true and fair view of financial reporting assurance, conformity of GAAP, assessing the adequacy of internal control in order to determine the level of reliance on the financial

statements on an annual basis. Due to the complexity of the business environment, it can be assumed that there are still more factors affecting the audit function that should be taken into account in business practice. In comparison to the field of external auditing, internal auditing is more helpful improving corporate governance. The purpose of this study is to review the literature in order to find the major internal auditing functions of listed corporation in Lebanon. Another objective is to measure the level of effectiveness of internal audit functions in relation with good governance and business sustainability and test them by using hypotheses.

## **2. INTERNAL AUDITING AND ITS FUNCTIONS/STANDARDS**

According to the Institute of Internal Auditors (IIA), internal auditing has been defined as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations” (Nagy & Cenker, 2002). Currently, internal auditors can be portrayed as consultants and the internal audit function of companies which is used to achieve corporate objectives and add value. As noted by Sarens & De Beelde (2006), internal auditors are currently expected to make things happen rather than just waiting to respond to it. It is argued that an effective internal audit function enables the board to perform its corporate governance duties. Mihret & Yismaw (2012) stated that internal audit effectiveness can be guaranteed with the help of four interlinked components: internal audit quality, management support, organizational setting, and attributes of the auditees. They argued that the internal audit function needs to be able to produce quality audits.

Several regulations have been changed as response to corporate scandals and the global financial crisis for internal auditors to prove the efficiency and importance

of their work professionally into the business environment. Regulations forced corporations, and especially their internal auditors to take a much broader spectrum of risks and controls into account that is no longer limited to financial controls (Baker and Writer, 2013). Internal auditors need to face the challenge of complex and frequent changes in regulations, as they have to assure the compliance of the company with those laws. As a consequence, many of them have an impact on the profession of internal auditing and define the tasks of internal auditors more precisely (Chambers, 2014). 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 processes.

A system of internal audit consists of policies and procedures designed to provide management with reasonable assurance that the organization achieves its objectives and goals (Monday et al., 2015). Internal audit function (IAF) is part of the internal monitoring system of the organization and therefore should be positioned within the organization such that the independence of internal auditors can be guaranteed. To ensure adherence to financial regulations, laid down procedures, policies and plans, internal audit units are established. The reliance of external auditors depends on the internal audit function which is fostered by recent regulations and standards with the aim of reducing repetitive work and managing corporate structure, culture, policies and strategies and dealing with its various stakeholders (ANAO, 2014; Monday et al., 2015; Asalou, et al., 2016). The past few years can be seen as a dynamic period for internal auditing. A lot of literature can be found about country and region-specific stages of development of internal auditing, presenting internal audit practices for instance in the United States, European countries, Latin America, Australia, India,

Estonia, Sweden, and China, Lebanon, Nigeria, Indonesia Jordan, Saudi Arabia, Malaysia, Kenya just to name a few (Rahmatika, 2014; Caratas et al., 2014; Shetwi, 2014; Grabmann, et al., 2014; Akinteye, 2015; Dominic, 2015; Gary, 2015).

Research on the country specific approach on internal auditing indicates great variations in the maturity of internal audit practices worldwide, which can be seen as the result of cultural differences, the economic development state of the country, and different regulations in corporate governance, macroeconomic trend for globalization and the rapid pace of change of modern business environment. Recent standards for listed hotels in Lebanon are to keep internal control system and auditors although their responsibilities and authority are not well practiced. Keeping organization's activities within the lines which are set by the code of conduct of the internal audit tasks by OECD has promulgated some core principles within the internal audit functions. The major IAFs from the literatures are as:

- a) Identifying and evaluating significant exposure to risk and contributing to the improvement of Risk Management.
- b) Evaluating the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information system and promoting their continuous improvements.
- c) Evaluating the reliability and integrity of financial and operational information and communicating appropriately.
- d) Evaluating the safeguarding of assets.
- e) Evaluating the compliance with laws, regulations, bylaws, and contracts.

f) Reviewing operations and programs to determine whether the results are in conformity with the objectives and goals.

g) Reviewing adequate control criteria to evaluate the accomplishment of objectives and goals making appropriate recommendations for the audit functions.

h) Promotion of appropriate ethical values, culture and ensuring effective performance management and accountability.

i) Preventing and detecting fraud by sharing information with other internal and external providers of assurance and consulting service.

### **3. GOOD CORPORATE GOVERNANCE AND ITS CHARACTERISTICS**

Successful governance of a country requires sustainable development, the benefit of future generations, clear assignment of roles and responsibilities, accountability of decision-making, accuracy and transparency of information, sound performance and the rule of Law (Marcel, 2013). It is built upon cooperation and participation between its government, its institutions and its citizens (Johnston, 2006). National governance manages a country's affairs at all levels, through the "participation of all citizens in the decisions that affect their lives". Therefore, all critical actors, whether commercial companies, hotels, banks or NGOs, should play distinct roles, "while part of their larger efforts is to promote better governance at the national level" (UN, 2016).

The issue of corporate governance (CG) coincided with the development of the corporate system in the UK, Europe, and the United States around the 1840s. CG is

defined as the system by which organizations are directed and controlled. Good governance in the sense of containing two-the values that uphold the desire of the people, and the values that can improve people's ability to achieve the national goal of self-reliance, sustainable development and social justice; and the functional aspects of an efficient and effective government in the execution of their duties to achieve these goals. Thus, good governance is based on four important principles: Transparency, accountability, predictability and participation. Effective corporate governance ensures that long-term strategic objectives and plans are set and the proper management structure is in place to achieve these objectives by maintaining the organizations integrity, reputation, and accountability to its relevant constituencies.

The OECD guidelines, annual report and Lebanon Securities Exchange Commission's Notification provides Corporate Governance Framework. This Framework does not provide any rules regarding internal auditor's role and responsibilities directly. Although the internal auditor does not have direct corporate governance responsibility, rather provides a great check on the governance system. The process of governance is focused on the development and maintenance of adequate and effective internal audit to protect assets from loss or steal. In this context, corporate governance is seen as a mechanism to monitor the actions, policies and decisions taken by management to achieve business objectives.

#### **4. RELATIONSHIP BETWEEN INTERNAL AUDITING AND CORPORATE GOVERNANCE**

It has been widely recognized that the role of the internal auditor becomes increasingly more important in terms of creating good corporate governance structures

(Allegrini et al., 2006; Carcello et al., 2005; Nagy & Cenker, 2002). In today's business environment, internal auditors are now providing management with a far broader range of information concerning the organization's financial, operational and compliance activities to improve effectiveness, efficiency, and the economy of management performance and activities (Rezaee, 1996). Corporate governance is expected to enhance the role of the internal auditor; and at the same time, the internal auditor also provides benefits to the external auditor (Holm & Laursen, 2007). Mihaela & Iulian (2012) analyzed the effectiveness of internal control and the Impact of Corporate governance on companies listed on Bucharest Stock Exchange. An effective internal control leads to a fair presentation of the financial statements and thus increases stakeholders' confidence in the financial statements.

In addition, Yassin et al. (2012) carried out a research that examines the relationship between internal audit and corporate governance in various commercial banks in Lebanon. The statistical analysis showed several significant tests supporting the hypothesis that the internal audit improves the quality of corporate governance. Kibet (2008) in his study carried out a survey on the role of internal audit in promoting good corporate governance in State owned Enterprises (SOEs'). His survey, however, is aimed to explore the role and the use of internal audit function in promoting good corporate governance in public sector enterprises and also the challenges faced by the internal auditors in SOEs. The study concluded that internal audit function played a significant role in corporate governance. Siddiqui & Podder (2002) examined the effectiveness of financial audit of banking companies operating within Bangladesh. For the purpose of this study, the audited financial statements of 14 sample banking companies have been analyzed. The study identifies seven (7) sample companies that have actually overstated their profits. Also, the research explores the level of



independence, objectivity and competence of the auditors, assigned for auditing banking companies.

From the above discussion, it is clear that the internal auditing is probably one of the most dynamic and yet important subjects to come to our attention and become increasingly more important in terms of creating good corporate governance structures.

From the above, it is clear that the regulation of corporate governance is the government's attempt to ensure that the corporation pursues its defined purposes and protects the interests of its owners.

## **5. MEASUREMENT OF THE EFFECTIVENESS OF INTERNAL AUDIT FUNCTIONS AND CORPORATE GOVERNANCE**

The most common definition of effectiveness is as the level of success of the organization in an effort to achieve the objectives and goals. Internal auditors operate in two Capacities First, provide independent objective assessment on the appropriateness of the organization's activities. Second, act as catalysts for change, advising or advocating improvements to enhance the organization's structure and practices. Theoretically, an organization with effective system of internal control is expected to achieve its objective efficiently and effectively, which is regarded as good corporate governance. On the other hand, an Organization with weak system of internal control will experience bad corporate governance. Also, the lack of internal controls and their deficient operation make hotels vulnerable to a number of risks, such as improper recording of accounting transactions, making unauthorized transactions, fraud, all these having a significant impact on financial performance and competitiveness (Mihaela & Iulian, 2012).

Empirically, the researchers found a positive relationship between internal control and corporate governance. Pratolo (2007) found that effective internal control has positive relationship with good corporate governance at State Owned Enterprises in Indonesia (SOEs). Mensah (2003) found empirical evidence in Ghana that effective internal control improves good governance practices and decreases corruption. Based on the same view to these findings, Nila and Viviyanti (2008) also found that internal control has a positive relationship with good corporate governance at State owned enterprises in West Java Indonesia. Asalou, et al., (2016) assessed the effectiveness of internal auditing in public organizations in Nigeria. Professional proficiency of internal auditors, quality of audit work, organizational independence, career and advancement and top management support were the variables used to determine internal audit effectiveness. Using multiple regression model, they showed that internal audit contributes positively to good governance in the public sector by effectively checking fraud and fraudulent activities. In a related study by Zwalif, I.M.A (2015), examined the role of internal control, internal audit enhancing the corporate governance in Jordan. Employing t-test, the hypotheses results showed that internal audit, internal control and organizational commitment had significant relationship with good governance.

Rahmatika (2014) examined the impact of internal audit function effectiveness on quality of financial reporting and its implications on good governance in Local Government Provinces in Indonesia. Employing structural equation modelling (SEM), the results showed that the effectiveness of the internal audit function had significant effect on the quality of financial reporting; internal audit function had significant effect on good governance application. Barasa (2015) examined statistical analysis of the role

of internal audit in promoting good governance in public institutions in Kenya. Internal audit function was measured by risk management, control process, and governance process, while accountability, transparency, effectiveness, efficiency and responsiveness measured good governance. Using correlation analysis, the study showed that there was a strong significant relationship between internal audit and good governance in public institutions. The empirical studies showed that much research on the subject matter have been carried out even in different countries. In this study effectiveness of internal audit functions is measured on the basis of six categories as independence, professional competence, scope of work, examination process and management support and sustainability support in Lebanon context.

## **6. RELATIONSHIP BETWEEN BUSINESS SUSTAINABILITY AND INTERNAL AUDIT FUNCTION**

Business sustainability is a pro-active approach to ensure the long-term viability and integrity of the business by optimizing resource needs, reducing environmental, energy or social impacts, and managing resources for environmentally friendly while not compromising profitability or compromising the ability of future generations to meet their own needs-Gary, (2015). According to United Nations Global Compact, (2015), the three key approaches and strategies are shifting in terms of future sustainability:

- i. Driving a company's strategy for developing sustainable products and services for the customers.
- ii. Providing importance to technology and innovation.

iii. Increasing partnerships and collaboration with suppliers and government.

Internal auditors can play vital role in maintaining business sustainability by rendering advisory services on sustainability programs, participating in committees established for sustainability or aspects of sustainability, including tests of sustainability in the audit programs to examine the policies and procedures and by identifying and managing strategic and operational risks and to create strategic advantages through its diversified functions Gaffoor, (2014). Dominic, (2015) addressed the issues to consider in sustainability auditing:

- a) Assist in the design/implementation of sustainability management systems
- b) Assist in creating sustainability awareness or training employees
- c) Budgeting the development resources utilization
- d) Perform supply chain and compliance audits
- e) Advise on the appointment of outside assessors
- f) Coordinate audit activities by external assessors

In this study, it is checked whether internal auditors can assist to evaluate all of these activities.

## **Methodology**

In Lebanon, different hotels are chosen as a target population. The hotels are 562; within 22 different sectors. No special sector is chosen due to understanding business variation associated with risk and internal audit functions and the necessity to ensure corporate governance system for satisfying economic and social needs. In this

study, non-probability sampling has been chosen due to fulfill the purpose. Total 50 hotels have been chosen for the study and one survey conducted for each hotel. The target respondents were member of audit committee, financial manager, head of accounts department and internal auditors of those hotels.

Data were collected using a questionnaire consisting of two parts: The first part aimed to identify the position of the respondent and their socio-demographic characteristics, while the second focused on the functional effectiveness in internal auditing. A Likert five-point scale was used to examine participants' responses to questionnaire statements. This study includes two main aspects: firstly, effectiveness of internal audit function which was measured by independence of internal audit system (INDP), professional competency (COMP), scope of work (WORK), examination process (EXAM), and management support (MSUP) and Sustainability support (SS) ability. Secondly, good governance (GOV) which is measured by fairness, transparency accountability and responsibility tested by developing hypotheses. The main hypothesis is:

**H1:** The effectiveness of internal audit functions enhances the pillars of corporate governance.

**H1/1:** The commitment to independence enhances the pillars of corporate governance.

**H1/2:** The commitment to professional competency enhances the pillars of corporate governance.

**H1/3:** The commitment to wider scope of work enhances the pillars of corporate governance.

**H1/4:** The commitment to efficient examination process enhances the pillars of corporate governance.

**H1/5:** The commitment to wider management support enhances the pillars of corporate governance.

Statistical techniques were applied in the analysis by using the mean, median, percentage and frequency. One sample t-test was applied to test the study hypotheses. Table 1 shows the distribution of respondents according to the position and in percentage from the 50 sample hotels.

**Table 1: Distribution of sample according to the position**

<b>Positions</b>	<b>Number of Respondents</b>	<b>Percentage</b>
<b>Member of audit committee</b>	<b>10</b>	<b>20%</b>
<b>Financial manager</b>	<b>9</b>	<b>18%</b>
<b>Head of accounts</b>	<b>14</b>	<b>28%</b>
<b>Internal auditors</b>	<b>17</b>	<b>34%</b>
<b>Total</b>	<b>50</b>	<b>100%</b>

## **Data Analysis and Findings**

### **Socio-demographic Characteristics of Respondents**

The socio-demographic characteristics of the respondents captured in this study include gender, age, academic and professional qualifications. The analysis in Table 2 showed that 84% of the respondents were male, while only 16% were the female

counterpart which it implies that more males are involved in internal audit function in corporate sectors. Majority (30%) of the respondents were in the age brackets of 36-40 years. This means young generation is coming forward to this profession. This showed that majority of the respondents were mature and knowledgeable to supply the relevant information. The analysis further showed that a very high proportion (90%) of the respondents had postgraduate qualifications in MBA/ Masters, degree. About 74% of the respondents are members of Lebanese International University (LIU), 10% are members of the CIS Technical College and Institute des Finances Basil Fuleihan in Lebanon or other professional bodies and the remaining 16% do not have any professional qualification degrees.

**Table 2: Distribution of Respondents by socio Demographic Characteristics**

<b>Characteristics</b>	<b>Classification</b>	<b>Frequency</b>	<b>Percentage (%)</b>
<b>Gender</b>	Male	41	83
	Female	9	17
	Total	50	100
<b>Age</b>	35 years or under	10	20
	36-40	15	30
	41-45	15	30
	46-50	3	6
	51 years or above	7	14
	Total	50	100

<b>Highest Academic Qualifications</b>	MBA	32	64
	MSC	13	26
	Honors/BBA	5	10
	Total	50	100
<b>Professional Qualifications</b>	CA/ACCA/FCA	37	74
	CMA/CFA	6	12
	NIL	7	14
	Total	50	100

## Hypotheses Testing

The following hypotheses were tested using t-test at 95% degrees of confidence. According to the decision rule, the hypothesis would be accepted if the calculated (t) is larger than tabulated (t) (Zikmund, 2000). The results of this test are presented in Table 3.

**Table 3. T-Test results to examine the hypotheses of the study**

Hypotheses	Median value	Calculated –t	Tabulated-t	Sig
H1	0.7239	19.37	1.96	0.00
H1/1	0.7114	17.53	1.96	0.00
H1/2	0.7486	18.65	1.96	0.00
H1/3	0.727	18.78	1.96	0.00
H1/4	0.827	18.76	1.96	0.00
H1/5	0.6054	17.50	1.96	0.00



### **Main hypothesis (H1) and sub hypotheses:**

As indicated in table 4, the value of calculated (t) for the main hypothesis amounted to 19.37 with the significance level of 0.00, which was larger than the tabulated (t) value at the level of significance of 0.05. These results proved that this hypothesis is accepted, which states that: The commitment to effective internal audit functions enhances the pillars of corporate governance. The major hypothesis is divided into five sub-hypotheses as follows. As the major hypothesis is accepted all other sub hypotheses are accepted at the significance level of 95%.

## **7. CONCLUSION**

More specifically, when we examine the effectiveness of different dimensions of IAF, we find that internal audit functions effectiveness depends largely on independence of audit system, professional competency and extensive support from the top-level management. The evidence from the study showed that the internal audit system was not absolutely independent and professional competence of the internal audit system was limited in meeting the challenges of complex business environment due to insufficient funds to successfully carry out its duties. However, scope of internal audit work was comprehensive, examination process was scientific and systematic, and management gives adequate support to internal audit process in most of the cases.

Thus, the effectiveness of internal audit function is moderate and hypotheses provides effective internal audit functions promote good corporate governance and business sustainability by enhancing fairness, accountability, transparency and

accountability of the listed hotels in Lebanon. This internal audit creates value addition to the business process. To get more effective internal audit function, the audit departments of the corporations need to be versatile in attaining a big-picture, proactive perspective on the entire organization-Value, integrated technologically, proficient to mitigate risks, improve processes for evaluating business, technology, control and governance challenges in their organizations.

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