NEXUS BETWEEN INTERNAL CONTROL SYSTEM, INTERNAL AUDIT FUNCTION AND AUDIT COMMITTEE: NIGERIAN DEPOSIT MONEY BANKS EVIDENCES

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ABSTRACT

An audit committee is a major part of the corporate governance (CG) of organizations delegated to report the organization's financial performance and ensuring an effective system of internal control. As assigned members and representatives of an organization, the audit committee is involved in its corporate financial reporting, oversight of its auditors (internal and external), risk management, and legal governing compliance. This study aims to focus on the audit committee and the internal control system (ICS). The objective is to examine the relationship between the audit committee and internal audit functions (IAF) and the extent to which they impact the banking sector's ICS. The empirical evidence gathered from the study reveals a positive relationship existing among the IAF and audit committee's interaction. The frequency of meetings held indicates a less significant impact on the firm. The relationship between the audit committee and internal audit significantly affects the ICS. The study's substantial evidence made the researcher conclude that the audit committee has a significant impact on the ICS in the banking sector. Therefore, an affirmative relationship must exist between the firm's internal audit and its audit committee to achieve an effective ICS.

Keywords: Internal Control System, Internal Audit, Meeting of the Audit Committee.

JEL Classification: G21, G30, G39, M42, M48, M49.

INTRODUCTION

The audit committee is set up to act on the board of directors as a self-governing voice on audit and corporate governance issues. Regulatory bodies have authorized organizations worldwide to establish an audit committee to ensure that the organization prepares and presents the financial reports' integrity. The audit committee reviews the firm's ICS, firm's IAF, and external audit functions and ensures and maintains the objectivity, independence, and integrity of all these functions. Abbott & Parker (2000) claimed that the audit committee's quality and effectiveness contribute to an organization's financial reporting quality. It is also expected that committee efficiency will increase the audit work's value. The CG code states that the audit committee, particularly the chairman, should meet with both the external auditors and the internal auditor without the executive director's presence. Deloitte's document guide (2018) states: *"the role of the audit committee includes, oversight of financial reporting and related internal controls, review of filings and earnings release, risk oversight, oversight of internal audit and independent auditors, other interactions with*

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management and the board as well as audit external communications."

Over the past decades, there has been a high-profile case of corporate failures, and such cases include Enron, Lehman Brothers, World Com and other firms. Consequently, the focus was on CG and its utility in leadership, internal checks, audit boards, disclosures, executives and auditors' independence. There is a general awareness of the need to pay more commitment to improving the audit committee in an organization, particularly in an economy's financial sector. A common trend associated with increasing failure was poor management, fraud, insufficient ICS, and insider abuse by board members and management. As shown in corporate failures, corporate governance's rampant failure has placed severe doubts on the audit committee's usefulness in fulfilling its statutory roles (Adagye, 2015).

The corporate failure cases were said to have occurred due to lack of a proper or weak ICS, lack of transparency, misrepresentation of financial information, weak disclosure in the financial report and non-compliance with organizational procedures and principles. Recent cases include Skye bank and Diamond bank in Nigeria, and it is essential to bear in mind that countless litigation has increased over the era in the Nigerian banking industry concerning managers in addition to auditors who have been discovered to be insufficient in ethical behaviour in regards to managing and reporting the organization's issues to its shareholders in some manner or another. As blame for banks failures is attributed to managers' failure, ICS, internal auditor, and external auditors, it is obvious that the audit committee may not be absorbed from the blame of banks' failures. The relevance of audit committee has continued to be a source of concern to shareholders, and the relationship of the audit committee, ICS and IAF is not well known. For this reason, this study examines whether the audit committee, ICS and IAF (Francis & Imiete, 2018).

LITERATURE REVIEW

Audit Committee

In the financial world today, more focus is sought to improve the audit committee in an organization. Arnold et al. (2001) explained the audit committee as a group of designated members of a firm who participate in the supervision of accounting and financial reporting policies and practices. The committee does not overtake the auditors and members of the management's duties, but to ensure an independent and objective financial statement is prepared consistently and competently. According to Carcello & Neal (2003), the audit committee is a body to ensure corporate accountability and qualitative financial reporting and serve as an essential control mechanism for ensuring efficient discharge of their responsibilities. The Sarbanes-Oxley Act of Law & Act, (2002) is a pillar to the audit function's essence in firms in terms of the audit committee. The audit committee cannot be completely explained without involving corporate governance.

According to Nwanji et al. (2019) corporate governance aims to ensure that the boards of directors do their jobs properly. It also protects shareholders' right, enhances disclosure and transparency, facilitates the board's effective functioning, and provides an adequate legal and regulatory enforcement framework. It addresses the agency problem through a mix of the company law, stock exchange listing rules, and self-regulatory codes. The principles and standards upholding the corporate governance body are established from international and local laws, bye-laws and codes of conduct constituted by organizations themselves. These standards ensure a compliant and principled corporate organization. The audit committee has been acknowledged as an effective tool for corporate governance to reduce fraudulent financial reporting practices (Al-Baidhani, 2014). The committees supervise the internal and external auditors as well as the management of the firm. The assignment of the audit

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committees are to monitor the process of financial reporting and disclosure, monitor the selection of accounting guidelines and principles, monitor the ICS, review three-monthly and annually the statements for public companies, discuss difficult accounting assessments and assessments prepared by the management and execution of new accounting codes or regulations, and recurrently communicate through financial managers, as well as monitoring those managers' competences (Roussy et al., 2020).

According to Tušek (2015), the audit committee and the internal audit improve the quality of a company's IAF. He further stated that strong, efficient communication between IAFs and audit committee would increase its performance. Another study assert that the audit committee and her characteristics positively impact firms' earnings management (Chandrasegaram et al., 2013). While many researchers supported the importance of audit committee to firms for good performance, others did not agree to the motion. Gunes & Atilgan (2016) disagreed with this opinion as his study showed that the audit committee has no significant impact on banks' performance. Empirical studies by Gunes & Atilgan (2016); Ibrahim as well as Bansal & Sharma (2016) did not support the theoretical expectation that a significant influence of audit committee on performance of firms. Many researchers worked on diverse indicative variables to determine the influence of the implementation of the audit committee, internal control and internal audit on firms' performance revealed that the presence of the audit committee, IAF and ICS in corporations commendably impacts their performance (Al-Matari et al., 2016; Chandrasegaram et al., 2013). However, some other studies argued that the establishment of the audit committee, internal control, and internal audit have no impact on firms' performance and no relationship exists between the variables (Gunes & Atilgan, 2016; Bansal & Sharma, 2016). This opposite conclusion of these extant studies couple with the ongoing corporate failure in the Nigerian banking sector serves as motivation to carry out this study.

Internal Control System

The concept of internal control has received attention in organisations' minds as a mechanism for building an effective operational system. It is a system that includes various control measures put in place by management to facilitate the conduct of the business of the firm as they aim to provide an all-encompassing assurance that the entire objectives of the organization will be achieved. The audit committee is assigned to monitor the principles observed in preparing financial statements and ensure the firm's ICS is corporate governance compliant. This empirical study aims to examine the effect of the audit committee on the ICS of banks. In Reinushini et al. 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a framework to be adhered by corporations in terms of their ICS. COSO provided a formal structure designated for monitoring the internal control function. The board's role in the firm and the audit committee by regulation to oversee internal control is a major part of CG. The goal of corporate management is to add value to the success and transparency of businesses and achieve this; they need an effective internal control and financial reporting system and an independent audit committee.

According to Sambo & Benneth, Audit Practice Committee described internal control as,

"The whole system of control financial and otherwise, established by management to carry on the business of the enterprise in an orderly and efficient manner, ensures adherence to management policies, safeguard assets and as far as possible the completeness and accuracy records."

Miliichamp in the same line opined that system of internal control is the entire financial control system and, otherwise, established the management system to conduct

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business in an organised and competent manner, certify compliance with rules, and protect assets and, to confirm that the accounts of the sole mechanisms of the company's control system are complete and accurate. Menon & Williams (1994) stated that, for an audit committee to be independent and maintain a high level of effectiveness, they should regularly adopt preventive and corrective measures to mitigate the ICS's weaknesses efficiently. According to the study of Al-Matari et al. (2016), they reported the audit committee's effectiveness symbolized by the frequent meetings held between the audit committee and internal audits. To this end, this study investigates the connection of the audit committee, the ICS and IAF in the banking sector.

ICS have certain features that provide the organization with sound assurance that administrative and accounting controls are working properly. This system consists of five interconnected mechanisms: information and communication, information and communication, control environment, risk assessment, control activities and monitoring. Control Environment is the internal environment of a firm, sometimes referred to as the organizations "*tone at the top*" means truthfulness, moral values, and ability of the entity's people. It also expresses the viewpoint and operational mode of administration; how the organisation assigns authority and duty, classifies and improves its employee, and the management's devotion and direction. Kinyua et al. (2015) identified the significant relationship between organisations' control environment and financial performance.

Risk Assessment connotes that the ICS's key role is to manage the risk important to the company's goals. A wide-ranging scheme of control helps protect the investment of investors and assets of the company. Increasing monetary scandals and corporate crises in the 1990s and 2000s has led to a growing demand for internal control and management risk model (Kajuter et al., 2008). This framework is now known as the Integrated Enterprise Risk Management Framework (COSO), widely adopted by many corporations worldwide. The Committee of Sponsoring Organization (COSO), defines Risk Management Enterprise as a method supported by management and staff of the firm, useful in the bringing up strategies throughout the corporation, intended to ascertain possible dealings that can affect the firm and to curb the threat, providing practical guarantee as to the accomplishment of the firm's goals.

Control Activities includes procedures as well as policies for ensuring that directives of management are implemented and takes place throughout the organization. It includes activities such as approvals, reconciliations, confirmations, separation of obligations. Information communication deal with companies' necessity to discover, capture as well as communicate information to the right people to fulfil their responsibilities. The board and others do monitoring within the company in relation to the control system. According to Newcomer et al. (2010), monitoring in the ICS enhances accuracy, transparency, strengthens accountability, and improves performance. Monitoring is the structure joined with the firm's internal audit task, and other observation methods, such as over-all managing the oversight events. In this context, the ICS and its key components (i.e. both financial and system controls), if implemented, systematically ensure the achievement of the system's objectives and involve both financial and system controls. Hence the researchers develop this null hypothesis to explore the internal control system function as its involved both financial and system controls as given below (Vicknair et al., 1993).

H3: *Financial and system controls should not be included in the ICS.*

Internal Audit

An internal audit is an administrative form of supervision where members of management are assisted by independent individuals who have been assigned the

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responsibility of monitoring and controlling the implementation and execution of an organization's policy, operations and financial reporting to ensure the activities are properly assessed against errors and fraudulent practices (Okezie, 2004). Internal auditors are appointed to carry the internal audit function as other members work in cooperation to ensure the organization is compliant to every requirement and laid down regulations. Institute of Internal Auditing (IIA), defined an internal audit as an alternative control technique in an organization whose major objectives are to assist members of management in business activities effectively and should engage in monitoring and evaluating financial and operational activities to guarantee conformity with established policies, regulations as well as plans. The internal auditors are also responsible for determining the qualitative performance and financial reporting of the organization.

Tapang & Ibiam said that the internal audit positively impacts the performance of firms and to this effect; the IIA (2019) suggested to organizations that a solid nexus between the audit committee and internal audit is necessary to attain an independent and effective IAF. Both the internal audit and audit committee's roles and responsibilities should be understood from both ends to work in synergy to achieve the objectives of the organization effectively. Building this relationship will help the activities of the internal audit to be efficiently productive, which provides a guarantee to the audit committee and members of management of the firm about its ICS in meeting the strategic objectives of the firm, the study derives a null hypothesis to determine the effectiveness from the relationship between the audit committee and internal audit function of banks as given below:

H1: *The audit committee is not related to the IAF.*

Meeting of Audit Committee

Previous studies have proven that corporations with the best possible frequent meetings of the audit committee result in fewer errors in presented reports (Abbott et al., 2004). Firms that hold frequent committee meetings are less probable to be punished for fraud and unwarranted aggressive accounting. Asiligwa & Rennox (2017) agreed that an effective ICS contributes to the sophisticated and well-structured banking sector environment. The meetings of the audit committee have a positive impact on the ICS. The study also suggested effective monitoring of the committee's meeting, and they should meet regularly in the financial year. According to the Corporate Governance Code the audit committee should meet minimum thrice a year. The audit committee and the external auditors should meet at least once a year and the executive board members should be absent. The committee is expected to support management in its duties, and the committee will review the process of financial reporting, control and financial management risk systems, audit processing, and the firm's compliance. With respect to the meeting of the audit committee, the study derived a hypothesis.

H_2: *The meeting of the audit committee does not affect the banks ' ICS*

Theoretical Framework

Agency theory

A company can be seen as a web of contracts consisting of several groups such as suppliers, customers, employees, bankers and so on, and these groups contribute largely to the company at a given price. This concept explains the association between the shareholders (that is the principal) and the agents (that is, the managers). This theory has served as a basis

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for existing business practices. Separating corporate management and ownership leads to an agency issue because management may not always act on the shareholders' interest (Jensen & Meckling, 1976). The current business practices were based on this theory. Shareholders represented by the board of directors' who bear the internal audit function's cost in protecting their economic interest. To demonstrate to the board of directors that the firm is under their control, managers (agents) invest in the internal audit function. Hence, information asymmetries between principals and agents may be reduced in managers' (agents) quest to prove that the firms' ICS and risk management are sufficient and efficient Sarens & Abdolmohammadi (2011) argued that

> *"The more the information asymmetry, the greater the need for people taking on a monitoring role, thus the more the company will hire internal auditors which lead to a relatively larger IAF. Investing more in the IAF means that there is relatively more staff in the company (as a proportion of total staff) whose major responsibility is actively monitoring the company. In the following paragraphs, we identify three traditional agency variables to include in our model and state our hypotheses based upon the literature."*

Stewardship Theory

The theory provides enlightenment on managers' behaviour when left alone with shareholders' assets in their control. They are referred to as "*responsible stewards*". The stewardship theory is an alternative view of the agency theory, where managers act on their self-interest at the shareholders expense. Donaldson & Davis (1991) argued that corporate performance would be linked to most in-house managers working to maximize shareholder profit. The stewardship theory framework constantly supports the board composition of majority executive directors. The theory believes that executive directors are reliable and trustworthy and will maximize and multiply the principal's value. In conjunction to this, Ramdani & Witteloostuijin (2010) supported the assumption of stewardship theory that says the Board of Directors (BODs) must consist of more executive directors because they remain more acquainted to the company and therefore, can maximise the resources of the company. Consequently, the stewardship theory framework was centred on the charade that managers are truthful and responsible individuals and therefore can act proficiently in making good use of the resources entrusted to their care effectively and efficiently (Nicholson & Kiel, 2007).

DEVELOPMENT OF HYPOTHESES

One of the subsets of the board of directors is the audit committee, and their role is to protect the interest of the shareholder (the principal). Audit committee monitors the agent (management) activities in relation to internal control, financial reporting and risk management (Law & Act, 2002). Audit committee and IAF two monitoring mechanisms but IAF a good information source for the audit committee in their quest to carry out their monitoring responsibilities Scarbrough. Hence the audit committee is associated to the IAF, and we then formulate the null hypothesis as given below:

H_1: *The audit committee is not related to the internal audit function.*

According to the CG Code, the audit committee should meet minimum thrice a year. To have more time to do a thorough job, the audit committee's meeting may have to be more thrice a year or may have been as much as possible within a year. This will give them more time to see that the IAF and ICS are adequate and effective. Hence audit committee meeting may affect the internal control, and we then formulate the null hypothesis as given below:

H_2: *The meeting of the audit committee does not affect the banks ' ICS.*

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H_3: *The ICS should not be both financial and system controls.*

METHODOLOGY

Adopting the cross-sectional research design, two cash deposit banks (Zenith and Guaranty Trust banks) in Lagos State, Nigeria were used as the sample for this study. Data was gathered both from primary. Based on the study's research objectives, a questionnaire was constructed and distributed to two cash deposit banks, each receiving 40 questionnaires for the primary data. Out of the 80 questionnaires distributed, 60 were returned and qualified for analysis, making the response rate 75%. The population and the sample consist of eighty administrative staff selected on equal basis for the case study of two banks in Nigeria: the Zenith bank and Guaranty bank. Random sampling technique was used in the selection of respondents. The statements required their perspective concerning the audit committee, internal audit, internal auditors and effectiveness of the ICS, measured on a five-point Likert scale. The dependent variables analysed were ICS, IAF, and internal auditors, which were used to measure banks' performance. The study from the annual reports assessed the frequency of meetings held by the audit committee, their relationship with external and internal auditors, the committee's experience, and the independence of management of the banks. The study assessed how the audit committee and the ICS had influenced banks' performance and operations through the questionnaire. Using the five Likert scale, respondents were able to choose from the scale of, *"strongly disagree (SD), disagree (D), no view (NW), agree (A) and strongly agree (SA)"* on the statements presented in the questionnaire.

RESULTS AND DISCUSSION OF FINDINGS

Respondents were given room to respond to the questionnaire statements based on their perspective about the function of internal audit, audit committee, and the ICS to assess the relationship of banks' audit committee, IAF and ICS. Approximately Ninety-seven of the respondents agreed that the audit committee should have an affirmative relationship with the internal audit to ensure banks have an effective ICS. Those who supported the statement that an efficient ICS promotes compliance with corporate governance regulations were 96.6%. This would reduce risks and ensure qualitative financial reporting. Approximately, Ninety-seven percent agreed that a relationship exists between internal auditors and the audit committee as it causes proper monitoring of the bank's operations. Ninety-two percent of the respondents were of the perspective that the ICS is influenced by the existence of financial expertise in the audit committee's composition.

Although Thirteen percent did not agree, 83.3% of respondents stated that the audit committee meetings should involve both internal and external auditors without the presence of the senior management. 91.7% of the respondents who filled the questionnaire stated that a relationship exists among the audit committee's meeting and banks' ICS.

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Concerning whether ICS should be on only financial control or cover both financial and system controls in banks, approximately Ninety two percent of respondents support that the ICS should consider both financial and system controls.

Ninety-five percent of respondents stated that internal control should involve other departments in the bank. However, Five percent did not agree with this statement. Respondents at approximately Ninety-eight percent were in concord that any report released by the audit committee should be considered by the Board of directors as this will enhance the ICS of banks. Ninety-eight percent agreed that internal control implemented effectively strengthens the financial control of banks in Table 1.

Table 1
PERCENTAGE OF STATEMENTS DATA

S/N	Statements	SA	A	No View	D	SD
1	The Audit Committee and internal Audit should work together for an effective ICS of the banks.	65%	31.7%	1.7%	1.7%	0%
2	The ICS of banks should be effective to ensure compliance with corporate governance regulations	48.3%	48.3%	3.3%	0%	0%
3	Audit committee and internal auditors in banking sectors are not related.	40%	56.7%	0%	1.7%	1.7%
4	The existence of financial expertise in the audit committee affects internal control.	51.7%	40%	5%	3.3%	0%
5	The audit committee members should have meetings with external auditors and internal auditors without top management to assess internal control effectiveness.	43.3%	40%	3.3%	11.7 %	1.7%
6	There is a nexus between ICS and audit committee meeting.	36.7%	55%	3.3%	5%	0%
7	The internal control system should not only be on financial control but also system control of the banks.	43.3%	48.3%	5%	3.3%	0%
8	The bank's internal control should involve other departments within the banks.	46.7%	48.3%	0%	5%	0%
9	The Board of directors of the Bank should consider any Audit committee' report to improve the banks' internal control.	45%	53.3%	1.7%	0%	0%
10	The effectiveness of the ICS contributes to strong financial control and Corporate Governance system of the banks.	40%	58.3%	1.7%	0%	0%

Hypothesis Testing

The analysis result showed that an IAF relationship exists with the audit committee. The analysis is based on the primary data in assessing the perspective of respondents. The analysis shows that a large number of them agreed with statement one that the audit committee and internal audit should work together to achieve an operational system of internal control. Therefore, we will accept the alternate hypothesis and reject the null hypothesis that states:

***H_1:** The audit committee is not related to the internal audit function.*

A high number of respondents who filled the questionnaire stated that the audit committee's presence and their frequency of meetings affect the ICS, while very few disagreed. This result is consistent with Tusek's studies, who identified that the audit committee's presence and their frequency of meetings significantly influences the value of the ICS. Hence, we accept the alternate hypothesis that says:

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H_2: The frequency meeting of the audit committee does affect the banks ' ICS.

The analysis from the respondents' point of view revealed that both financial control and system control should be subjected to internal control. It showed that most respondents agreed that financial control and system control of banks should be part of ICS. As many viewed the statement to be positive, we, therefore, accept the alternative hypothesis and reject the null hypothesis that states that;

H_3: The ICS should not be both financial and system controls

CONCLUSION

The purpose of the study was to see how the Sarbanes-Oxley Act reinforced the relationship between ICS, IAF, and audit committees. The frequency of audit committee meetings, the committee's size, and the committee's connection with bank internal auditors were all investigated in this study. The study found that the IAF-audit committee relationship had a significant impact on banks' ICS. The frequency with which the committee meets also has an impact on the ICS in banks. This study's empirical results support the theoretical expectation that the audit committee's existence and frequency of meetings have a positive impact on banks' ICS. The literature review basing this study on ICS, IAF, and audit committee shows that prior studies by researchers assessed the frequency of audit committee's meetings, size of the committee, the IAF, and presence of the internal auditors in the audit committee's meeting. The results of this study indicated that not all criteria, such as meeting frequency, accurately assess the audit committee's impact. As a result, future researchers should conduct a thorough investigation into the features of the audit committee and ICS.

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CONFLICT OF INTEREST

Conflict of interests concerning this study does not exist

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