

The effect of the Internal Auditing on Financial Performance

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The effect of the Internal Auditing on Financial Performance

Introduction

An internal audit is taken less seriously because many organisations think that the accounting department can play the roles of internal audit department. This is why many companies hire internal auditors to work within the accounts department (Deloitte, 2018). The internal audit department is very important in formulating policies that can help control the business operations (Steinbart, & Dilla, 2014). This study seeks to evaluate the impact of internal audit on financial performance. The study will be done at M&S Simply Food Liverpool Street Broadgate, which will be used as a case study in this project.

M&S Simply Food Liverpool Street Broadgate is a franchise where people can eat a variety of food. This means that many financial procedures take place at the Franchise, which includes procurement, receipt of orders, as well as receipt of payments. The retailer has to work with a budget of expected revenues and expenses, and the control of these financial variables affect performance.

Background

Liverpool St Broadgate Simply Food is one of the franchises under Marks & Spencer (M&S). M&S is a UK based retail company that owns food outlets and supermarkets. The company engages in the sale of products such as clothes for both gender, furniture, food products and drinks, kitchen products, and beauty products. The company sources its products from many countries, which are then distributed to various outlets (M & S, n.d). The activities of the retailer are decentralised; hence there are managers at each branch, who supervises other departments.

There is internal auditors in this franchise, and there is a need to find out the importance of audit in this organisation.

Statement of the problem

Since organisations such as M &S and its franchises such as Liverpool Street Broadgate are in business, there is a need for them to evaluate whether their activities create value. The creation of value can be achieved if there are more net profits that are generated. This is possible if there is a reduction in the costs of operation as well as increased sales revenue. The aim of this report is thus to evaluate whether there is a relationship between investment in internal audit and the financial performance of organisations. It will evaluate how organisations can achieve stock control and reduce waste so as to achieve good financial performance. In this case, M & S, and more specifically, Liverpool Street Broadgate is used as a case study.

Research objectives

The overall aim of the research is to evaluate the relationship between internal audit and financial performance of a business. The following are the other objectives of the study;

- i. To find out the relationship between internal audit and financial performance of businesses
- ii. To evaluate factors that would limit the achievement of benefits of internal audit

Research questions

The research will be guided by the following research questions;

- a. How does internal audit affect the financial performance of businesses?
- b. What factors would limit the benefits of internal audit activities?

Importance of the study

The study will help retailers decide whether they should invest more in internal audit or not. If there is a positive relationship between internal audit and financial performance, then it would be reasonable for businesses to invest more on internal audit (Lenz & Sarens 2012). The research will also help tell how the roles and effectiveness of the internal audit department can be improved.

Limitations of the study

The major limitation of the study is that it is based on primary data conducted through interviews; hence the correctness of the report is based on the truthful responses from the individuals sampled. The report is also limited to the study of M & S and its franchise, hence may not apply to all businesses operating in the UK.



Literature review

General literature

According to Coram, & Moroney (2008), companies that have an audit department are more likely to identify fraud as well as errors in the financial accounts or activities, so that they can make necessary steps to prevent misappropriation of company resources. Self-reporting helps create confidence among the stakeholders as they are assured that their resources are well managed, and there are low chances of misuse. They can also make reliable decisions based on more accurate financial reports. Coram, & Moroney (2008) is mainly based on theory, and there are no data collected to prove that the findings match the theories for all organisations.

Lenz & Sarens (2012) on the other hand argues that there are limitations that are faced by the internal audit departments of various companies. The study revealed that the internal auditors are agents of the management and the audit committees of organisations. This means that they have direct control over the auditors, and can influence what they report. With such control, fraud and errors may not be reported to the external stakeholders, to protect the image of the organisation but they can take steps to correct the errors and stop fraud. The problem is that the management may collude with the internal auditors to misreport any fraudulent activities that originate from the managerial level. While Lenz & Sarens (2012) highlights some of the limitations of internal audit, it does not base its findings of a case study or any organisation which would make it possible to better understand the limitations in a better way. It is important to back the arguments on limitations of internal audit or real case scenarios that one can refer further. This can make the study more believable.

Steinbart & Dilla (2014) explains the role of the internal auditors in ensuring that information systems are functioning well. Businesses in modern society rely on the use of

information systems in recording most of their transactions. Internal auditors who have technical knowledge in information systems are of greater help to organisations in that they can tell if there are errors or fraud that is being perpetrated using the systems. The research thus suggests that internal auditors would be more effective if they had technical skills to evaluate information systems. The study by Steinbart & Dilla (2014) fails to highlight how information systems can be manipulated and also give the possible impacts of such events. This makes the explanations by the authors of less importance since professionals may never understand how the findings can be implemented in a real life scenario.

For the case of M&S Simply Food Liverpool Street Broadgate, the sale of food requires that there is supply of inputs and proper sourcing and payment for the same. Internal auditors seek to ensure that there are controls that would ensure that the company pays only for the goods that are received at the business. The controls also ensure that whatever revenues are received are accounted for and do not end in the pockets of some employees who may be fraudulent. There is a need to understand that it is difficult to trust all employees, hence controls can help ensure that there is proper accountability and minimised theft and loss of funds.

Theoretical framework

This section evaluates the various theories that are related to internal audit activities;

Agency Theory

The management of companies is linked to agency theory because there is the principal (the shareholders) and the agent (managers) whose interests conflict. The shareholders would wish that they get more value from their invested capital, and the managers are interested in earning a higher salary. An example is the fact that some managers would adjust their financial

accounts to reflect good performance so that they can get salary additions (Volosin, 2008). This conflict of interest requires a strategy that can ensure that both stakeholders achieve their goals.

The costs of supervising the managers to ensure that they are pursuing greater value for the shareholders can be minimised if there are other neutral individuals who can do so at minimal costs. Internal auditors can bridge the gap between the shareholders and managers, by ensuring that the right processes and procedures are followed in doing business (Pitt, 2014). In this case, internal auditors at M&S Simply Food Liverpool Street Broadgate would ensure that the interests of the shareholders are protected. The management is not likely to collude with employees, since internal controls can specifically tell who is engaging in fraud. Internal controls at M&S Simply Food Liverpool Street Broadgate would ensure that the potential loopholes of loss of money are identified and sealed. The criticism of the model lies in the fact that the internal auditors are under top management, and can be sabotaged by ensuring that they receive less budgetary allocation (Pickett, 2013). They can thus be forced to collude with the management and leave loopholes for theft of funds.

Contingency theory

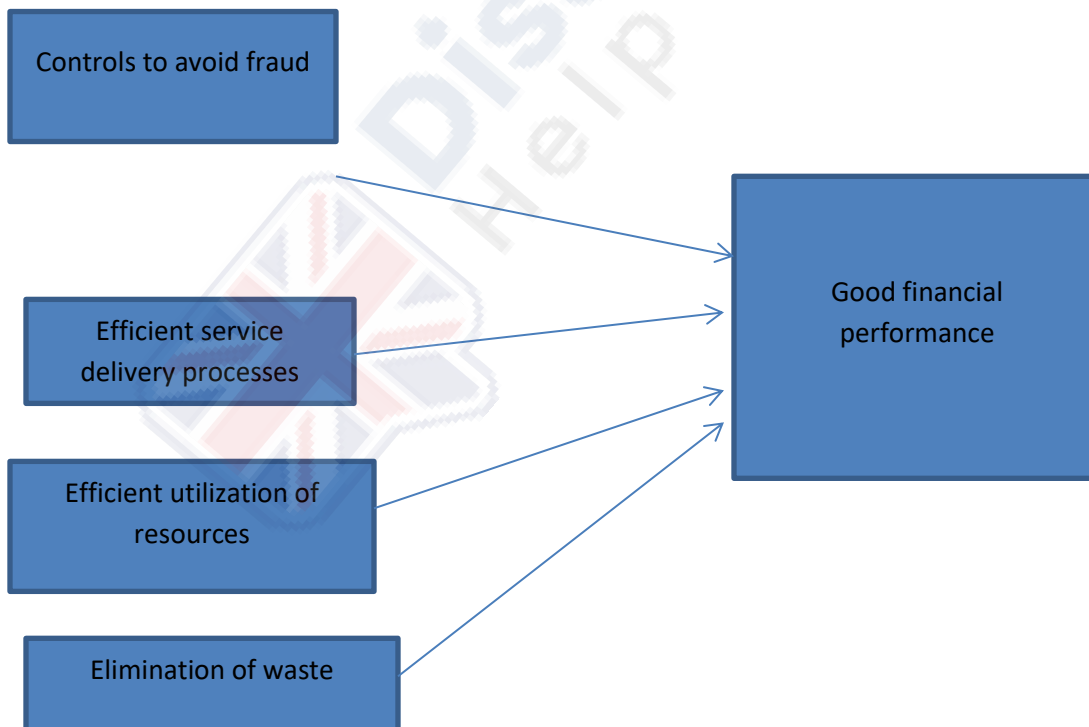
This theory suggests how companies should be managed and decisions made. The theory suggests that there is no specific way of leading an organisation or making decisions, and instead, the circumstances that an organisation is facing should determine the decisions made and how they are made (Donaldson, 2001). This would suggest that the decision on whether to set up an internal audit department would depend on the circumstances that an organisation is facing (Pickett, 2013). Not all organisations would require setting up an audit department unless there is a need. It would thus be wrong to criticise the organisations that have internal auditors who are

under the accounting department, as long as such internal auditors are doing their work appropriately and creating value for their organisation.

Contingency theory suggests that there should be no laid out procedures for departments such as internal auditors, and the activities should depend on the situation. If business operations are recorded in the information system, then controls should be on the system (Tosi, 2009). It should be possible to identify the risky areas that need evaluation in the workplace, to ensure that the loss of organisational resources is protected (Ghofar, & Islam, 2015). It thus means that the internal auditors need the independence to make decisions that are of importance to the organisation.

Conceptual framework

The following is the summary of the conceptual framework;



The analysis shows that various aspects of the internal audit would be very important in enhancing financial performance internal audit helps eliminate fraud that is crucial in increasing sales of an organisation. It also helps enhance the utilisation of resources, such as ensuring that the human hours can be accounted for. It helps achieve effective delivery of services because of the improved systems and processes (Ghofar, & Islam, 2015). Internal audit also helps eliminate waste in an organisation because every resource is accounted for. Costs are reduced, and productivity of resources such as employees is improved. Reduced costs and increased revenue generation in an organisation leads to increased financial performance.

There are other variables that would help improve the financial performance of an organisation. However, the conceptual framework that helps achieves the above values is very important in ensuring that there is an increase in financial performance.

Gaps in literature

There is literature evaluating how internal audit should be structured, how it can achieve positive results and the challenges that are faced. There is also a study of the relationship between financial performance and internal audit. However, such a study has not been done in the UK, and more specifically, in the retail sector such as M &S and its franchises such as Liverpool Street Broadgate. This research thus focuses on the UK market and the M & S chain of outlets to find out whether the internal audit process has a positive impact on financial performance.

Past literature also uses data to show a correlation between financial performance and internal audit. However, there is no clear, detailed explanation of how the internal audit process affects the financial performance. This study uses primary data to get information from managers who work within organisations that have internal auditors. It will thus answer the research

questions based on the qualitative data that is from the experiences of the managers in the company that is under study.

Methodology

Introduction

This section explains the procedures that will be used in collecting the needed data, the target population, the sampling procedure and how the data will be analysed. The choice of methods is also justified.

Research design

Ethnographic study

The research design can be described as ethnographic, considering that it seeks to understand the audit activities of a selected organisation. It thus evaluates culture as well as processes of a certain organisation that has its own beliefs about internal audit activities. This approach is selected because it can help understand the value of audit in the selected organisation and then project what would be happening in other organisations.

Snapshot

Data will be collected once for each of the sampled units for study. This means that there will be no continuous observations of the study population. This is done considering that reasonable data can be collected at the set dates without having to make observations in the future.

Time horizon: cross-sectional study

The study will involve the collection of cross-sectional data that shows the relationship between internal audit and the financial performance of the business. The study will be conducted within the next few days and this means that it will not be based on past or future occurrences. The choice of this method is based on the view that there will be no much changes in audit activities or objectives in the near future at the select organisation.

Qualitative data

The data required in this case is qualitative in nature, as there will be interviewing of the managers who are well informed about the internal audit activities, and the financial performance aspects of the organisation that is under study. The choice of this method is that the data needed is subjective in nature as it involves personal evaluation of the processes in the selected organisation.

Philosophy: realism

The philosophy chosen to guide this study is realism. This philosophy believes in the independence of human mind. As such, the views of the respondents in relation to the audit activities will be the main guide in arriving at the findings. The assumption is that the employees can understand the way audit activities help the businesses. The choice of the philosophy is based on the fact that the study seeks to get information that exists with those already in the field. Therefore, the study can be successful if there is value in the independence of these subjects.

The method is chosen considering that the need for internal audit varies from one organisation to another as per the contingency theory. It also varies over time, and this is why the

choice for cross-sectional data is preferred. The data collected from the sampled representatives of the organisation under study will be compared with the past literature, to help tell whether it applies to the organisation or not (Salmons, 2015).

The research will involve the collection of primary data through interviews. The choice of this method is based on the fact that it will allow the collection of more data and seeking clarifications when there is a need.

Target population

The study focuses on M & S retail outlets, to understand what they achieve in their internal audit activities. The retailer will represent the other retailers doing the same business; hence the report will be useful to such retailers too. The individuals in the accounts department, the managerial level as well as in the audit department will be selected to represent the total population of employees in the M & S retail outlets.

Sampling procedure

The study will use purposeful sampling, to ensure that the relevant individuals are selected. Not all employees at M & S understand the role of internal audit, and what is achieved. This is why some outlets will first be sampled, and then the right individuals who can respond to the survey questions will be selected for study (Galletta, & Cross, 2013). The target individuals will be 10, so that even if less than this number is interviewed, then there will be enough data collected to answer the research questions.

Data collection procedure

The first step will be seeking permission from the management to collect the management. It will involve writing to them and informing the reason for the study and the kind

of data that will be collected. The second will be the preparation of the survey questionnaire, and doing a mock interview with a classmate to find out whether the instrument will help collect the needed data to answer the research questions (Roulston, 2010). This means that modifications of the interview questions will be done when needed.

Once the interview questions are ready, I will talk with the sampled individuals to schedule a meeting. The interview will take around 30 minutes. During the responses, there will be a recording of the responses in a notebook and the same will be recorded using a phone so that it can be reviewed in the future. The data collected will then be summarised to get the main issues raised, in preparation for analysis.

Data analysis

The data collected from the interviews will be analysed using descriptive statistics. The responses will be described under selected themes in a way that answers the research questions. The findings will then support using secondary sources (Guest, Namey, & Mitchell, 2013). The choice of this method is based on the fact that the data collected is qualitative in nature, which cannot be converted into figures.

Inductive approach

Inductive approach will be used as the method of data analysis. The data collected will be evaluated to understand the some evidence that they present. This evidence can then be compared with the findings from the literature so as to understand whether there are any differences and what could be the cause of the differences. The choice of this approach is based on the fact that the study collects data from the field, and has to evaluate whether the data matches with already existing theories.

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Appendix 1: Interview questions

1. How does internal audit help reduce the costs of operation of businesses?
2. How does internal audit help increase revenues hence increase the net profits?
3. What are the important characteristics of an internal audit that can help the department effective?
4. What roles does the internal audit department play in your organisation?
5. In what ways has the department helped the company perform well financially?
6. What is the annual internal audit budget at your outlet?
7. What are the net profits generated at your outlet?

