

ORIGINAL CONTRIBUTION

Formation of Organizational Forms of Internal Control and Audit

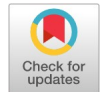
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Abstract— The purpose of this research paper is to improve the processes of designing, implementing, and applying audit methods and procedures within the corporate governance system, to clarify and formulate a single and understandable apparatus of “corporate governance”, which will allow us to determine the place and role of internal audit in the corporate governance system. The paper uses a complex methodology for studying the topic, including methods such as analysis and synthesis, comparison, and statistical assessment. Key findings of current study are a system of quantitative and qualitative indicators that expresses the economic interests and control parameters of a group of corporate governance entities. It will help to evaluate the level of performance of the analytical facility using the paired comparison method. Relevance of the topic is related to the fact that the creation and development of internal audit function are connected to the creation and development of joint-stock companies caused by post-soviet privatization of property in Georgia. There is a substantial volume of research that gives a general perspective about the internal audit of corporate governance, but the creation of the conceptual model of internal audit in the corporate governance system and its auditory assessment methods remain the least scrutinized field of economic science.

Index Terms— Corporate governance, Internal audit, Internal control, Strategic management, Taxes.

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Introduction

The purpose of this research paper is to improve the processes of designing, implementing, and applying audit methods and procedures within the corporate governance system, to clarify and formulate a single and understandable apparatus of “corporate governance”, which will allow us to determine the place and role of internal audit in the corporate governance system.

The aim of the work is to improve the organization of internal audit in the corporate management system, which should answer a modern reality. In addition, the research aims to develop recommendations for improvement of internal audit standardization, practical tools, and methods, which will facilitate the functioning of internal audit and balancing the interests of corporate governance participants. The subject of research is the combination of theoretical, practical, and methodical problems of Internal audit existing in the corporate management system.

The scientific innovation of this study is to develop the theoretical and practical grounds of internal audit and improve the audit methodology, which allows the optimization of internal audit and improvement of its functionality in the corporate governance system. Besides:

- Extended formulation of the internal audit as one of the control elements and the system of the processes is provided. It is set out as a concept of a complex of analytical procedures, which essentially distinguishes our definition from the definition of internal control

in international documents where the audit is defined as the process;

- It is proven that the creation of organizational forms of internal audit is determined by the level of development of corporate governance. To this end, five phases of the evolution of the Georgian corporation were analyzed, each of which was characterized by more sophisticated and high-level forms of audit systems.

In this work, the implications of our research have sought to respond to a number of research questions related to the development of an effective management and control system; Creating an organizational model through which the company promotes the formation of corporate rules and procedures. Future Research Areas are Internal Audit in the Corporate Management System. The growing interest of the corporate governance system to internal audit matters and problems is caused by the economic situation in the country, by the necessity of:

- Creation of effective mechanisms of asset management;
- Integration of Georgia into the world economic community under the influence of globalization;
- Growth of attractiveness of Georgian corporations for western investors;
- Competitiveness of Georgian corporations on a world market.

Specifications of development of Georgian economy facilitate reevaluation of international and Georgian audit experience and its implementation in the corporate governance system. In light of the recent international

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scandals developed in the world that showed control problems, the significance of internal audit has increased. There is a clear vision in the world about the need to increase the openness of true information and follow the modern tendencies of development, but that is still doubted by Georgian companies. In addition, the majority of Georgian companies ignore the social function of the business, causing them not to meet western standards of corporate governance.

The importance of internal audit is particularly relevant for the formation of effective corporate governance due to the imperfection of the legislative basis for the settlement of internal conflicts between owners and managers.

Internal auditors' activity is an additional resource that promotes further perfection of corporate governance, risk management, and control processes. The paper presents ways to improve the elements of the internal audit organizational mechanism; Internal audit methods for key criteria of the operating system.

Literature Review

In Georgian publications, there are no differences in the concept of "corporation management" and "corporate governance". Attention is focused on the activities of management and the importance of the shareholders' general meeting, the board of directors or other governing parties is insufficiently considered.

In the Report of the Committee on Financial Aspects of Corporate Governance in the UK (Cadbury Report) there is one of the first definitions of corporate governance in which corporate governance of the company is defined as a system through which management and control of the company are carried out. International Financial Corporation (IFC) defines corporate governance as a structure and procedures of company management and control over them. Some authors characterize corporate governance as the interaction between management personnel, first of all with owners and other corporate entities.

In the Code of Corporate Conduct corporate governance is defined as a system of interaction between shareholders and corporation management that includes its Board of Directors and other interested parties through which the rights of shareholders are realized; Mechanisms that allow shareholders (investors) to control the activities of the company's management and resolve problems with other groups of influencers.

Lawyer scholars consider corporate governance as "well organized legal regulations of organizational relations, with which the corporation represents and protects the interests of owners and investors". In the definitions of corporate management, its role in the formation of the effective control structure is underlined. For example, by the interpretation of the economic dictionary "corporate governance is a combination of economic and administrative mechanisms, which helps to enforce shareholders' ownership rights and to form corporate control structure. As well as the interaction system between the management of the company, its Board of Directors, shareholders, and other interested parties for the realization of their interests".

In the corporate governance principles developed by the Organization for Economic Cooperation and Development (OECD), based on the systemic approach, the following definition is defined: "Corporate governance may be termed as to the system which affects the direction and control of the corporations. The corporate governance brings a harmonious relationship in the structure of a corporation regarding the rights and responsibilities among the different personnel in a corporation and specifies the rules and procedures that how the managers of the different levels, the board of directors, shareholders, creditors, auditors, regulators, and other stakeholders shall make decisions and help themselves to cooperate in the following corporate affairs. "

The corporate governance theory is the result of a generalized practice of corporate governance, where each of them is characterized by its specificity: a) concept of agent relations (agency theory), b) managerial concept, c) strategic management concept and d) social responsibility theory. Strengthening the human factor in the management of companies is the main feature in the modern economy. Despite the active participation of our country in the condition of globalization a lot of problems still exist. The essential role of solving the given problems is granted to the audit. For making the right decisions, governmental agencies as well as economic entities should possess complete and accurate information. Since the area of economic activity overshoots the country's borders and the local legislation, international legislation, as well as legislation of the country in which business relationships are carried, should be taken under consideration, the process of an audit of such type of operations is a quite complex and lengthy process. Thus audit should be carried out by highly qualified specialists. The effective management of the company that is a precondition for economic growth and sustainability is depended on the reports prepared by auditors (G. Sulashvili & Murvanidze, 2017).

The need to increase the effectiveness of the management in organizations determined the necessity to improve legislative/normative base and introduce new control mechanisms. To strengthen the efficiency of the accounting and control system it is necessary to improve Georgia's normative acts, the existence of complete information on the financial performance of organizations, and the results. This is only possible through using international accounting standards and fully harmonizing them with international standards (Boonvut, 2017; Dwi & Renny, 2017; M. Sulashvili et al., 2018).

The aim of the research is to find ways of improving the accounting and control methodology, by establishing of which the financial situation of the enterprise will be evaluated objectively and the control will be activated, which is directly related to the correct and smooth accounting for the purpose of reaching the institution's goals and accomplishment of tasks (Pailodze & Kutateladze, 2018).

For State-Owned Enterprises companies in order to reduce the level of debt and should be the efficient use of assets as well as still maintaining and enhancing competent audit committees. (G. Sulashvili & Murvanidze, 2017; Nasution & Sukmadilaga, 2019).

Research Methodology

Improvement of the internal audit methodology considering international practice in the corporate management system promotes the sustainable development of the economy and, ultimately, is an important tool for improving the social conditions of society.

The paper uses a complex methodology for studying the topic, including methods such as analysis and synthesis, comparison, and statistical assessment. Significant contributions to the development of theoretical and methodical aspects of audit, internal audit, and control in the corporate management system were made by The International Institute of Internal Auditors and specialists such as: Adams (2005); Arens (2003); Robertson (2003) and others.

The paper conveys the thoughts of both Georgian and foreign scientists and practitioners about the implementation of foreign experience of Internal Audit in the Georgian business environment. There are different approaches to internal control and audit that belong to different authoritative organizations and authors. The topic of this research is internal audit and its role and importance in the development of the economy and we believe it is necessary to further develop internal audits in Georgia in order to be compliant with modern requirements.

Internal audit issues of corporate governance are still insufficiently covered in the special scientific literature. There is a substantial volume of

research that gives a general perspective about the internal audit of corporate governance, but the creation of the conceptual model of internal audit in the corporate governance system and its auditory assessment methods remain the least scrutinized field of economic science.

Results and Discussion

As a result of the integration of definitions, we have developed the following definition: Corporate Governance - is a system of organizational-economic, legal, and social relations between parties, which is directed through internal and external mechanisms to balance their interests in order to achieve corporate goals in the strategic perspective as well as for long-term and short-term periods. In the definition of Strategic Management Concept compliance, strategic character goals are added and in respect of concept of business social responsibility, social relationships are added. The most successful corporations understand that the recognition and acknowledgment of ecological and social interests of the society, in the long run, makes it possible to improve the corporate reputation and improve its performance because the interaction of the subjects of the corporate governance system ensures their synergy in relations with external counterparties, which are directed to:

- Establishment and operation of an effective management and control system;
- Establishment of organizational model, through which the company represents and protects the interests of investors;
- Creation of a structure that contributes to the distribution of rights and obligations among participants of corporate relations;
- Formation of the reporting system, corporate rules, and procedures;
- Creation of control over the outcomes of activities that contribute to achieving common corporate objectives, increasing efficiency of the company's activities, and provision of investment returns.

As a result of the accumulation of corporate governance experience, its theoretical understanding process has undergone several phases of development; each of them produced a new approach to the emergence of its essence, the special features of corporate management were distinguished, and the demand for internal audit increased.

Opening the essence of internal control and audit approaches, the development of their organizational forms in the conditions of the evolution of the joint-stock company, determining the essence and the function of the internal audit enable the formulation of the basic conditions of the internal audit concept.

The concept of internal audit for Georgia's practice is a relatively new phenomenon (its comparative development has been happening for the last ten years), although it is actively used abroad since the late nineteenth century. Establishing and developing internal control in Georgia is based on the advanced practices of the world, such as the COSO model and guidance, the Sarbanes-Oxley Act (SOX), and the Turnbull report.

A basic methodological document aimed at control of the company's activities can be called the COSO model and manual: "Internal Control-Integrated Framework" which has an appendix "Reporting for Outside Parties" (according to 1992 and 1994) ([The Committee of Sponsoring Organizations of the Treadway Commission, 2013](#)). In the document "Risk Management of the Organization -Integrated Model" ([The Committee of Sponsoring Organizations of the Treadway Commission, 2004](#)) has opened the different aspects of risk management and control as the function of the special function.

The Sarbanes-Oxley Act made significant changes in the field of financial reporting in public companies. By the adoption of the Act the regulatory body - supervisory board over-reporting - was created in public companies; with the rise of the audit committees' roles the demand for auditors' independence was presented; criminal liability was brought for the

violation of fake financial statements or for other violations of the legislation; other necessary measures have also been initiated to increase the transparency of financial statements and to reduce risks. The importance of internal control has been opened in the Turnbull Report ([ICAEW, 1999](#)). Subsequently, in 2005, the report was reviewed to discuss the issue of openness of information. Currently, the report reflects factors that are taken into account when assessing the level of the internal control system. In particular, its role: in raising corporate stability; In the assessment of efficiency, which is in conformity with the expenses and the profit received from it; in assessing the number of risks considering the threat level.

Internal Audit is directly dependent on the goals and objectives set for the Internal Auditor, which depends not only on the development of stock companies in the country but on the financial and economic development stage of the company. The development of the company creates the need to improve the management function and in particular the control function. With the growth of the organization and the complication of the management functions, the company's top management can no longer physically manage all the existing processes in the control system.

This leads to a control crisis that motivates the management to separate internal audit functions from the internal control system and to create an independent body of internal audit. A control efficiency crisis can be overcome by reconstructing and coordinating various organizational structures for controlling and monitoring. The main function of controlling bodies in the process of the formation of an economic entity in control of the maintenance of assets. During the financial instability of the company, management processes are getting difficult; this leads to the necessity of expanding controlling functions, starting from the control of property maintenance ending with management consultations. In terms of sustainable financing of the company development, Internal Audit activities include a broader range of issues: The performance indicators of the company activities; the analysis of management processes; the efficiency of use of resources; the protection of social security of the least protected entities in corporate governance. For understanding the meaning of the objectives of internal audit it is necessary to review internal audit not as a result of the simultaneous incident, but as a result of constant complications of control forms.

In the framework of the organization's development theory, we find it necessary to identify the stages of formation of corporate governance in Georgia and to determine the organizational forms of control that correspond with these stages. Before the Soviet era, corporate form in Georgia was not functioning due to a low level of market relations. Although the subsidiary companies of foreign corporations have acted in Georgia, they have never had independent Georgian content. In the early Soviet period (1921-1923), the history of the formation of joint-stock companies in the form of syndicates and trusts relates to new economic policies, which in turn led to the need for organizing control. In 1923, the introduction of the Civil Code established the revision commission as an internal control body under the legislation.

The revision commissions remained in the organizations during the liquidation of joint-stock companies. Additionally, public control bodies were functioning with them. The internal control of the Soviet period was mostly effective, preventing large-scale violations. The prerequisite for creating a modern corporation was the development of a joint-stock company. The above-mentioned process originated from the reduction of state ownership and privatization. As a result of the evolution of the joint-stock company in Georgia, the corporation was developed as one of the organizational and legal forms of entrepreneurial activity.

In the 1990s. economic and political changes in Georgia led to a significant change in the system of controlling bodies; In particular, in 1990 the public control bodies were abolished. In the post-Perestroika period, we identify the five stages of the development of joint-stock companies (Table 1).

Table 1
Subject Name and Number of Credits

Stages	Characteristics of a stage	Organizational characteristics of corporate governance	Organizational forms
1992-1994	Establishment and privatization of the enterprise. Property rights and management powers are united	Owners perform themselves	Structural function control, there is no specialized form of control
1995-1998	Distribution of equity ownership in favor of majoritarian share holders. Establishment of highly concentrated insider property. Establishment of legislation on joint-stock companies	Owners are related to each other in relationships that are built on the need to solve all issues of management of the joint-stock company; They are obliged to create a revision commission.	Structural function control. Creation of revision commissions and controlling-auditing services
1999-2001	The process of dividing ownership rights and management powers	In the companies, owners lose their managerial functions. Relations between proprietors are transformed between owners and executive management.	Structural function control. Start the formation of an internal control service.
2002-2005	Development of transnational corporations with territorial divisions	The new subject of management-hired managers - was created	Structural-functional control. Creation of Audit Committees with the Board of Directors Creating Specialized Services Start of creating internal audit services
From 2006 to present	Further Development of corporations in Georgia	Introduction of progressive methods of corporate relations in modern corporations. Strengthening corporate control over the work of the management	Structural function control. Development of specialized services

First stage (1992 - 1994). Privatization of state enterprises contributed to the restoration of joint stock companies and to the composition of owners of joint stock companies. In most cases there was combination of property rights and management rights in a single person, i.e., the fully functional specialized form of control did not exist. But the structural-functional control remained from the planned economy continued to exist but inefficiently.

The second stage (1995-1998) - The beginning of the intensive distribution of ownership of stock companies in favor of majoritarian shareholders. They are trying to deceive and/or strengthen corporate control over the company. The Georgian legislation on joint-stock companies made it mandatory to select revision commissions. The task of the Commission was to examine the company's annual financial and economic activities and to prepare a relevant report for the General Meeting of Shareholders. The Revision Commission was accountable to the highest management authority - the general meeting of shareholders.

In addition to the revision commissions, the control-revision service starts functioning, which aimed to detect and prevent abuse of resources. The control-revision service reported to the highest executive management.

The third stage (1999-2001). Stock ownership concentration reached an important level at the end of the 90s, resulting in the formation of majoritarian owners groups and the controlling packages of companies. The majors began to delegate management functions to qualified managers. That is, the process of dividing ownership and management functions in which the shareholders lose their management functions, their relationship is transformed into a relationship between owner and executive governance.

Fourth stage (2002 - 2005). A significant part of the stock companies was transformed into corporations. A new entity of corporate governance was established - hired managers. As joint-stock companies stepped into financial markets, strategic partnerships were created in the process of attracting investments.

As a rule, external investors represent large and medium businesses and foreign companies become dominant owners. Capital is divided into ownership capital and functional capital, resulting in the existence of a need for a competent and trusted board of directors. The Board of Directors needs the objective source of information about the state of affairs of

the Company to perform its functions. The Board of Directors should be sure that managers perform their duties in terms of reliability of company reports; try to reduce risks; create and support effective management systems and internal control. Audit committees are created on the board of directors for this purpose.

Generally, the main functions of the Audit Committee are:

- Control accounting (financial) reporting process and procedures;
- Control the reliability and efficiency of risk management and internal control systems;
- Preparation of recommendations for the selection of external auditor for the Board of Directors;
- Ensure the necessary conditions for the effective functioning of the internal audit.

Thus, the purpose of creating an internal audit is to increase efficiency in the interests of the company's business. The fifth phase (from 2006 to present).The modern stage of development of the company, for which intensive development of internal audit is characteristic. It is characterized by:

- Corporations are starting to regroup according to the World Stock Market requirements;
- Corporate Code of Conduct, obligation to pay dividends, the introduction of independent directors and so on;
- The corporation becomes more open to investment, which means the interest of any applicant who has been known to him and his / her co-owner with the conditions guaranteed by the law;
- Quality of corporate relations increases, rising transparency of corporation activity and its structure and ownership;
- International standards for financial reporting are introduced.

In the corporations the auditory components are interacting with all participants of the process: this includes periodic meetings, discussion of the tasks and responsibilities of the participants, discussing the issues of financial statements, and company control issues.

Proper management of corporate governance ensures efficient use of capital by investors and investors, provides for the interests of stakeholders and promotes accountability of its management bodies both before the executive directorate and the shareholders. As a result, corporations operate for the benefit of the society as well as to support foreign and local investors in order to attract more "patient", long-term capital.

In this research paper, the five stages of the development of joint-stock companies are identified. The paper shows the research of the development phase of the company from 1992 to the present; the paper presents a systematic review of the conceptual foundations of internal audit and is presented in a table - development of organizational forms of control in the conditions of the evolution of the joint-stock company.

Limitations and Future Research Directions

This study has opened up avenues for future researchers to explore and implement new forms of internal control and audit. Since this study has investigated the audit and control systems with reference to Georgian systems, hence, more research with respect to other policies and procedures of other countries could make the findings more precise and reliable. Moreover, analysis of financial accounting and internal control management features should also be carried out in future.

Conclusion

The following conclusions can be made as follows:

1. The precondition for the formation of modern corporations in Georgia is the evolution of the joint-stock company, with the development of which organizational forms of control are being developed. Each stage of development of a joint stock company is characterized by increasing complexity of management; As a result, the reliability of the old organizational form of control decreases, which leads to the necessity of reorganization;
2. Formation of the effective organizational structure of control, on the one hand, allows analyzing and evaluating management processes and workability; On the other hand, it is directed towards the prospect and can offer reasonable recommendations for improvement of corporate governance.

Thus, the development of the modern corporate environment and adaptation of its control and organizational forms of the audit results in changes in the necessity to reform theoretical, methodical, and practical papers (standards and norms) that regulate internal audits in the corporate governance system. The conclusion provides generalized results of the research and concludes that internal auditors' activities are an additional resource that promotes the improvement of corporate management, risk management, and control processes; furthermore, the improvement of internal audit methodology in the corporate governance system in the framework of international practice contributes to the sustainable development of the economy and, ultimately, represents an important tool for improving the social situation of society, methodological and applied recommendations of the author.

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