



The Obstacles of Internal audit in the Assessment of the Variable Part of Executive Remuneration: Exploratory Study in Joint-Stock Companies in Algeria

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Abstract :

To minimize the risks associated with the opportunistic behaviors of managers, in particular the risks associated with their remuneration, a corporate governance strategy must put in place several control mechanisms, among these mechanisms, internal audit. But the problematic is the independence or not of this control mechanism. For this, the objective of this article aims to study the obstacles of internal audit in its mission of evaluating the methods used by senior executives to achieve the objectives related to the variable part of their remuneration, in Joint stock companies in Algeria. In this context, we used a quantitative descriptive method in the form of a survey, the results were processed and analyzed by the SPSS software. The results obtained show that the hierarchical reattachment of the IA to the CEO and the combined functions of the CEO hamper the role of the auditor in his mission of auditing remuneration.

Key Words: Internal Audit, Remuneration Audit, Executive Leaders, Obstacles of Internal Audit, Joint-Stock Companies.

JEL Classification: M42, M52.

Introduction

Like other countries, Algeria has been confronted to certain financial scandals, such as: Sonatrach, Sonelgaz, Khalifa, BNA, Bcia, BEA, Badr, East-West motorway, Générale des concessions agricoles, port, DGSN, Algeria Telecom, SAIDAL, National Dam Agency, Oref, Oaic, Erriad, Faki. etc. these scandals are the result of a lack of reliability of information and the existence of illegal behavior toward regulations and directives. Indeed, this has called into question the internal control and audit mechanisms in the governance of Algerian companies.

These behaviors can be described as deviant for several reasons. One of these reasons is remuneration, which is an element of interest to executive leaders, and which may lead them to act against the interests of shareholders in order to increase their variable part of remuneration (Broye G., Moulin Y., 2010).

At this stage, the main goal of corporate governance is to protect the interests of shareholders through several mechanisms controlling these opportunistic behaviors, among these mechanisms is the internal audit (Mandzila, Eustache Ebondo Wa, 2006), but the problem is the independence of this internal audit



(Vinten, G, 1999). It is in this perspective that is directed the objective of our study, which aims to show the obstacles of internal audit in its monitoring of the methods used to achieve the objectives relating to the measures of the variable part of executive remuneration, in joint-stock companies in Algeria.

For this, we have proposed two hypotheses:

H.1: The attachment of the internal audit function to the General Management prevents the auditor from limiting the abuse of the variable part of senior managers in joint-stock companies in Algeria.

H.2: The function accumulation of the CEO affects the execution of the operational audit mission of the procedure for evaluating the variable part of senior managers in joint-stock companies.

In this regard, to test our hypotheses, we have chosen to use a quantitative descriptive method in the form of a survey, the data are processed and analyzed with the SPSS software (statistical package for social sciences).

I. The previous research :

Previous studies have examined the various mechanisms for controlling the remuneration of executive leaders. Among these studies, Vigliano M-H. (2007) examined the impact of board control on the remuneration of executive leaders. Its results show that there is a strong correlation between the level of remuneration of executive leaders and the control exercised by the board of directors.

(Dardour A., 2008) has demonstrated that the independent members of the Board of Directors have a positive influence on the level of remuneration of the company's executive leaders.

(André P., Khemakhem H., Sakka O., 2006) In their 27th Congress of the Francophone Association of accountancy, argue that the majority of studies confirm the existence of a positive relationship, between the independence of the board of directors and the discipline of executives through remuneration. They point out that these two governance mechanisms are complementary or even substitutable. They also point out that a sufficiently independent board of directors has an important power to directly control the decisions of executive leaders.

(Broye G., Moulin Y., 2010) , argue in their study that the existence of an audit committee in the company positively influences the remuneration policy.

(Cazavan-Jeny A., Margaine J., Missonier-Piera F, 2009) Have shown that the presence of a remuneration committee in a company regulates the level of remuneration of executives according to their performance.

For (Piot, 2005) the existence of a remuneration committee has an important role in the discipline of executive leaders, in particular, to supervise management in the context of the relation between shareholder-executive leader relationship. The result of its study shows that the coaching on remuneration issues is necessary, and it seems legitimate to refuse access of executive leader to the compensation committee.

(Theresa F. H., John J. Shon, Renee E. Weiss, 2011) they strengthen the literature review in this area, indicating that there is a relationship between executive



remuneration and the effectiveness of internal control structures.

(Mandzila, Eustache Ebondo Wa, 2006) Maintains that the audit and internal control system reduces the risks of the over-remuneration of managers and the risks related to stock options, as according to the researcher, these represent a major risk for shareholders and the company.

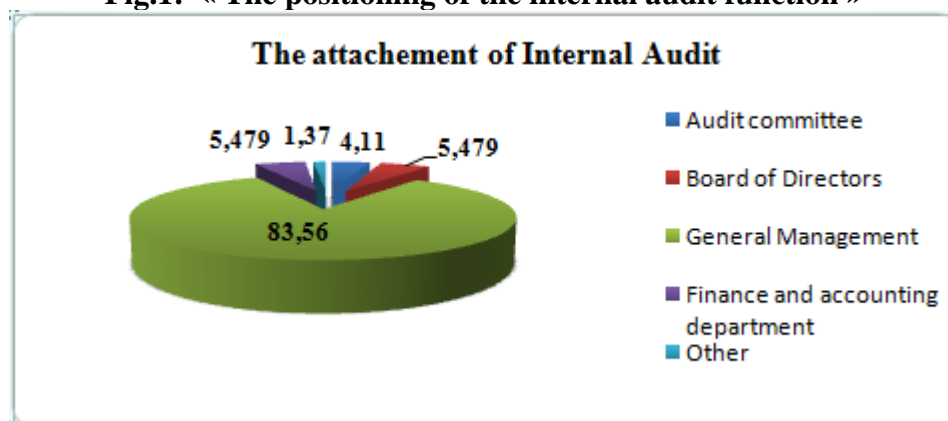
As for the study by (Koudri Ahmed, 2008) confirms that the variable remuneration of executives in Algerian public companies has become fixed because of poor selection of performance criteria linked to the variable part on the one hand, and the lack of a rigorous management control system within these companies on the other hand.

All this research has led us to adopt this perspective in order to answer the questions that we think are associated with this research. To do this, we used a pre-survey of various managers of joint stock companies and internal auditors in Algeria. This is to investigate and analyze the obstacles that faces the internal audit mission of the remuneration of executives in joint stock companies in Algeria.

II. Obstacles to internal audit of executive remuneration in joint stock companies in Algeria

In order to respond to our problematic, we conducted a study on joint stock companies (SPA) in Algeria, whether public or private, working in several sectors of activity (construction, industry, energy, hydraulics, mechanics, electronics, textiles, etc.) employing at least one executive leader. This study took place in different parts of the country. We distributed a survey to 140 joint stock companies (40 in the west, 60 in the center and 40 in the east. We were able to obtain 90 responses out of the 140 targeted companies (35 in the west, 25 in the center and 30 in the east), this represents 64.28% of the population. Then, after processing and selecting the answers, we excluded 17 of them that did not reply to all the questions. Finally, our study was reduced to a batch of 73 companies, representing 52.14% of our sample. These survey were sent to the internal audit managers.

Fig.1: « The positioning of the internal audit function »



Source: Established by us

The question of the hierarchical reattachment of internal audit determines the



level of independence of the internal auditor, and to what extent can he exercise his missions in complete freedom. In our survey interpreted by this graph, we note that 4.11% of internal audit managers report to audit committees, 5.47% report to boards of directors. On the other hand, 83.56% are attached to the General management, 5.47% are attached to the Finance and Accounting department and 1.37% are attached to other departments in particular, the Human Resources department.

Concerning the internal audit managers who report to the General Management, most of them have informed us that the audit report must be approved by the General Manager and can be modified if necessary, before being transmitted to the Board of Directors.

On the other hand, very few internal audit managers say that they make audit reports available to the auditees and to the General Manager, indicating that the content of these reports was the subject of disagreement, but at the same time, these reports are not a challenge to funds. Let's say that this attribution is much more about the personality of the internal auditor. It also appears that in general, internal auditors are rarely invited to present their report to members of the board of directors.

For internal audit managers who report to the board of directors, it is true that they are more independent than the previous ones, and especially when the CBD does not combine the function of managing director. Otherwise, the situation for the auditor is relatively less comfortable.

Thus, to fully assume his role, the internal auditor must absolutely demonstrate competency and professionalism, but this is not enough, since he should use a fine intelligence to impose himself reasonably in cases of conflict of interests between shareholders and managers.

As for the other attachments of the internal audit function, in particular to the Accountancy department, HRD, etc. auditors do not hide their dissatisfaction and admit that they frankly do not have the conviction that they can exercise their tasks freely.

For the moment, the audit committee, when it exists, remains the best way to guarantee the internal audit function its independence to carry out missions with ethics and objectivity. This is because the audit committee is mainly composed of members of the board of directors and who themselves are responsible for ensuring the implementation of the strategies decided by the shareholders.

The audit committee is then sovereign, it is indeed the Audit Committee which appoints the Internal Audit Director, gives its opinion on the hiring of auditors, fixes the salaries of auditors, and it is still the Audit Committee which validates the work programs, reports and any other work that may be assigned to internal auditors.

Generally, the audit committee organize at least 4 meetings per year, and at each meeting, the internal audit director is invited to present and explain the conclusions and recommendations resulting from the audit work carried out.



The Chairman of the Committee, with the assistance of the Internal Audit Director, shall present the summary of the final audit report to the Company's Board of Directors, which shall take the necessary resolutions if necessary.

1. Test of assumptions:

In order to test whether the pressure from the superior undergone by the internal auditor constitutes an obstacle in checking the assessment of the objectives related to the remuneration (variable part) of senior executives in joint-stock companies in Algeria; we used the cross-tabulations to measure the degree to which the hierarchical reattachment to general management and functions combination of the chairman and chief executive officer affect the independence of the internal auditor.

1.1. The hierarchic reattachment of internal audit to the general management of the company

To test whether the reattachment of internal audit to general management prevents the internal auditor from limiting the abuse of the variable part of senior executives in joint-stock companies in Algeria. We have tried to answer the following questions through cross tables:

Question 1: Does the reattachment of the audit function to the general management of the company influence the assessment of the variable part of senior executives that are related to the achievement of assigned objectives?

Table 1: « The impact of the hierarchic reattachment of internal audit function to the General Management on the assessment of the variable part that is related to the objectives achieved »

		Have you already undertaken an audit on the variable part of the executives' remuneration?		Total
		No	Yes	
The audit reattached to the GM	No	9	1	10
	Yes	54	9	63
Total		63	10	73

Source: Established by author

The table above shows that out of 63 internal auditors reporting to General Management, 54 auditors does not carry out this type of audit and only 9 auditors do. We also observe that even the 9 internal auditors not attached to the General Management do not control the variable part remuneration of senior management.

Question 2: Does the hierarchic reattachment of internal audit to general management influence the assessment of each element of executive remuneration?



Table 2: « The impact of the reattachment of the internal audit function to general management on the assessment of elements of executive remuneration »

		Do you examine the remuneration elements of senior executives that appear on their contracts?		Total
		No	Yes	
The audit reattached to the GM	No	8	2	10
	Yes	43	20	63
Total		51	22	73

Source: Established by author

In this table, we note that 43 of the 63 Internal Auditors reporting to the general management do not assess the remuneration elements for senior executives, while another 20 auditors do. In another hand, 2 out of 10 auditors not reattached to the general management assesses this control without any influence.

Question3: Does the hierarchic reattachment of internal audit to the General Manager prevent the verification of benefits in kind granted to senior executives?

Table 1: «The impact of hierarchic reattachment of internal audit function to senior management on checking the benefits in kind »

		Do you check the benefits in kind granted to executives?		Total
		No	Yes	
The audit reattached to the GM	No	8	2	10
	Yes	44	19	63
Total		52	21	73

Source: Established by author

The table above shows that 44 internal auditors reporting to the GM do not audit the in-kind benefits granted to senior executives, although 19 auditors audit them. On the other hand, 8 auditors do not audit them although they are independent of the GM and 2 internal auditors perform this task freely.

Question 4: Does the hierarchic reattachment of the internal audit function to the general management prevent the auditor from ensuring that the measurement parameters of the variable part of remuneration are not overestimated?



Table 4: The impact of reattachment of the internal Audit function on the guaranty of the measurement results of the variable part of remuneration»

		Do you ensure that the results of the variable part measurement criteria are not overestimated?		Total
		No	Yes	
The Branch Audit	No	6	4	10
	Yes	42	21	63
Total		48	25	73

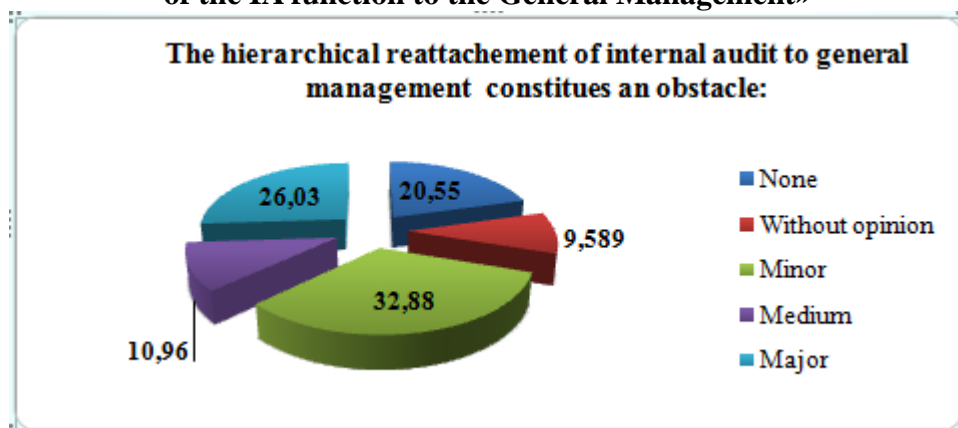
Source: Established by author

This table shows that 42 internal auditors who are attached to the GM do not check the measurement parameters related to the variable part of senior management, while 21 auditors do. As for the 10 auditors who are not linked to GM 6 among them do not ensure the reliability of the results and the 4 others did not face any obstacles.

a. Comments : Following these observations, we note that the same results are repeated in the various Items. This implies that the hierarchic reattachment of the internal audit to the company's general management, affects the independence of the internal auditor. However, we noted that some auditors exercise this type of control despite their connection to the GM, which led us to ask these auditors what was the reasons. Indeed, these internal auditors tell us that, in this case, there are two reasons that allowed them to carry out this type of mission in complete freedom: the strong personality of the auditor and the rigorous behavior of the General Manager. Then, we found that other internal auditors, and despite their reattachment to the Board of Directors, are not that independent in the execution of control of the remuneration of senior executives, when the company's CEO chairs' the Board of Directors.

b. Results and validation of the first hypothesis: To further clarify the results of our tests, we sought the advice of internal auditors regarding this obstacle:

Fig. 2: «Degree of obstruction of hierarchic reattachment of the IA function to the General Management»





This graph clearly shows that 32.88% of internal auditors find that the reattachment of internal audit to general management is a minor obstacle.

These auditors indicate that if the managers have no deviant behavior, the auditor can exercise his role independently. On the other hand, 26.03% of internal auditors report that the reattachment of the internal audit function to the GM is a major obstacle, saying that despite the auditor's competency, the auditor is often led by the director, which breaks the independence of the internal auditor. Next, 10.96% of auditors suggest that the reattachment of the audit to the GM is a moderate barrier depending on the nature of the mission. On the other hand, 20.55% of internal auditors believe that the GM does not constitute any obstacle for the auditor; on the contrary, this connection strengthens the power of auditors toward managers. Finally, 9.58% of internal auditors prefer to give no opinion on this point.

On the basis of this analysis, we are rather in favor of the first sub-hypothesis, which argues that the attachment of the internal audit function to the General Management influences the execution of the operational audit mission on executive remuneration.

1.2. Function accumulation of the CEO

To test whether the accumulation of the functions of the CEO affects the execution of the operational audit mission of the evaluation procedure of the variable part of senior executives in joint-stock companies in Algeria; we are going to follow the same cross-tabulation process to answer the following questions:

Question 1: Does the accumulation of the functions of the CEO have an impact on auditing the variable part of senior management related to the achievement of the assigned objectives?

Table2: « The impact of the CEO on the assessment of the variable part of remuneration related to the objectives achieved »

		Have you already undertaken an audit on the variable part of the executives' remuneration?		Total
		No	Yes	
Who chairs your board of directors?	CBD	20	2	22
	CEO	43	8	51
Total		63	10	73

Source: Established by author

The previous table shows that, 43 internal auditors whose boards of directors are chaired by a CEO do not undertake an audit on the variable part of remuneration for senior managers in relation to the method of achieving the assigned objectives. In addition, 20 internal auditors of whose board is chaired by a Chairman of the Board of Directors CBD, do not carry out such missions.

Question 2: Does the function accumulation of the CEO influence the evaluation of



the elements of remuneration for senior executives?

Table 3: «The Impact of the CEO on the Assessment of Executive remuneration Elements»

		Do you examine the remuneration elements of senior executives that appear on their contracts?		Total
		No	Yes	
Who chairs your board of directors?	CBD	17	5	22
	CEO	34	17	51
Total		51	22	73

Source: Established by us

Concerning the evaluation of the elements of executive compensation, we observe that 34 internal auditors which have a board chaired by the CEO, do not examine these elements. On the other hand, 17 internal auditors do.

Question 3: Does the functions accumulation of the CEO prevent auditing the benefits in kind granted to senior executives?

Table 4: «The CEO's Impact on the Audit of Executive Benefits in Kind»

		Do you check the in-kind benefits granted to senior executive?		Total
		No	Yes	
Who chairs your board of directors?	CBD	16	6	22
	CEO	36	15	51
Total		52	21	73

Source: Established by us

The table shows that 36 internal auditors, which have a board chaired by a CEO, do not audit the in-kind benefits granted to senior executives. As well as 16 internal auditors that have a board chaired by a CBD do not audit them.

Question 4: Does the accumulation of the CEO's functions prevent the internal auditor from ensuring that the measurement parameters of the variable part are not overestimated?



Table 5: «The Impact of the CEO on ensuring the Measurement Results of Variable part of remuneration »

		Do you ensure that the results of the variable part measurement criteria are not overestimated?		Total
		No	Yes	
Who chairs your board of directors?	BCP	18	4	22
	CEO	30	21	51
Total		48	25	73

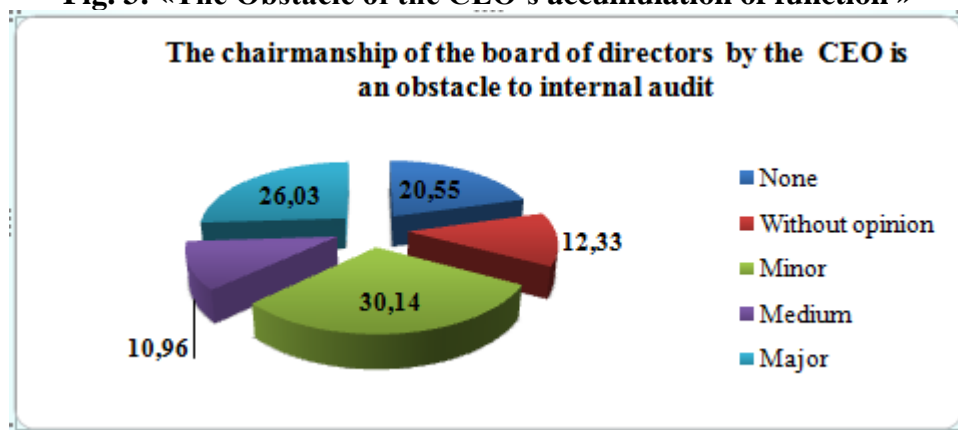
Source: Established by us

This table shows that 30 internal auditors that have a board chaired by a CEO, do not check if the measurement parameters of the variable part are overestimated. Also, the 18 internal auditors that have a board chaired by a BCP do not carry out this audit.

a. Comment: In this context, the results show that the function accumulation of the CEO influence the performance of the audit mission on the remuneration of senior executives. As for auditors with a board chaired by a BCP, and who do not exercise control over the variable part, are faced with the obstacle of the General management, because they are functionally attached to it, even if they are hierarchically depending to the board of directors.

b. Results and validation of the second hypothesis: To strengthen and enrich our results, we asked the internal auditors about their opinions concerning the obstacle of combining the functions of CEO and General Manager.

Fig. 3: «The Obstacle of the CEO's accumulation of function »



Source: Established by us

This graph shows that 30.14% of internal auditors argue that the Board's chairmanship by the CEO is a minor obstacle, because the internal auditor reports first to the CEO as general manager before they report to the board of directors. They insist that the first obstacle is the reattachment of the internal audit to the GM despite being in the organization chart of the company attached to the board. In



addition, 26.03% of internal auditors find that the CEO's chairmanship of the board is a major obstacle because the CEO always has the final word at the board meetings. And if this CEO acts opportunistically, the audit report will have no role. Also, 10.96% of auditors say it's a medium obstacle. On the other hand, 20.55% of internal auditors indicate that the CEO's function accumulation do not constitute any obstacle. While, 12.33% of internal auditors prefer to give no opinion.

Therefore, we confirm the second hypothesis which suggests that the combination of the functions of the CEO constitutes an obstacle for the internal auditor in joint-stock companies in Algeria. so, this obstacle is absolutely significant for the operational audit of executive remuneration.

2. Summary of the results:

All these results show that the operational audit of executive remuneration mission faces several obstacles in the companies of our sample. These obstacles are related, according to our study, to the reattachment of the internal audit function to the General Management or to a board of directors chaired by a CEO. Indeed, this does not allow the auditor to extend his controls without the agreement of his superior. In this case, the auditor suffers from a major problem of independence, especially if his superior has a deviant behavior. These results confirms that the pressure of the superior imposed to the operational auditor constitutes an obstacle in the verification of the performance of the objectives related to the remuneration (variable part) of the senior managers in joint-stock companies in Algeria.

However, these results do not prevent us from showing that in some companies, internal auditors perform their mission of operational audit of executive remuneration. For this, during our investigation we attempted to question these auditors concerned by this type of mission, on the conduct of this control and on the contribution of this executive remuneration audit to reducing conflicts between shareholders and executives. As we have tried to unveil the reality of the internal audit function in Algerian companies.

Conclusion

In this exploratory study, we found that the audit of remuneration of senior executives is not carried out systematically, it is not because it is less important, but rather because it is about 'a very sensitive subject, which may lead to conflicting situations between the management and staff of the audit function. This is the result of attaching this function to general management or to another department of the company.

The study also asserts that the dependence of the internal audit function on general management is a major obstacle preventing internal auditors from acting in the interests of shareholders by delimiting any stratagem induced by the leaders.

Our results also show that, in the case where companies are attached to the board of directors, another problem appears, this problem consists in the functions accumulation of chairman of the board of directors and general manager. This combination of control and management functions effectively reduces the



effectiveness of corporate governance control mechanisms, in particular the effectiveness of the internal operational audit mission.

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