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THE ROLE OF INTERNAL AUDITING IN AVOIDING BANKING BANKRUPTCY

Dr. Mohammad Abdulwahid Jayyas

Department of, College of Education, Ibn Rushd for Human Sciences, University of Baghdad, Iraq

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Abstract

This paper explores how internal auditing can help banks to avoid the risk of bankruptcy. It focuses on the effectiveness of internal auditors and their role in evaluating risk management within banks. The paper examines the tools they use and the recommendations they provide to help banks make informed decisions to minimize bankruptcy risk.

To gather data, a questionnaire was created with two main sections: the first assesses the efficiency and commitment of internal auditors, while the second evaluates how internal auditing contributes to identifying bankruptcy risks. This questionnaire was distributed to bank institutions, internal auditors, and university professors in the relevant field, resulting in a total sample of 37 participants.

The researcher employed a descriptive analytical approach to test the hypotheses and analyze the results. The findings, analyzed using the Statistics Package for Social Sciences, indicate that internal auditing plays a statistically significant role in reducing the risk of banking bankruptcy.

Introduction

Banks play a crucial role in driving economic growth, particularly in developing countries where their impact can be even more evident. These banks possess a unique ability to adapt to changing market conditions, which allows them to effectively promote economic development. They contribute to job creation and the generation of wealth through strategic investments, making them indispensable for efforts aimed at economic recovery and stability in these regions. However, as banks begin to experience growth and expand their range of activities, they often encounter an increase in the complexity of their management and organizational structures. This growth typically involves diversifying the services offered to customers and scaling up their workforce to meet higher demands. While such expansion is beneficial, it simultaneously leads to heightened complexity, which significantly increases their exposure to a variety of risks, including the ever-looming risk of bankruptcy.

As the banking systems evolve, the intricacies of managing operations can become overwhelming, and it is during these times that understanding and managing risks becomes a necessity. To effectively navigate these challenges and mitigate potential threats that can have serious consequences not just for the bank but also for the economies they serve, the Board of Directors often seeks the expertise provided by internal auditing. Internal audits are invaluable tools that assess and enhance the internal control systems established within banks. By conducting thorough evaluations and identifying areas for improvement, internal audits play a vital role in reducing the likelihood of bankruptcy, thereby promoting the overall stability and continuity of the organization. This ensures that banks are better equipped to succeed despite the complexities of the business environment, ultimately contributing to their long-term success and sustainability.

Research Problem

Based on what has been mentioned above, the following research question is developed:

Does internal auditing significantly help to reduce the bankruptcy risk for banks? To explore this question, the following sub-questions are formulated:

1. Are there significant differences in how internal auditing principles are applied?
2. Are there significant differences in how procedures to reduce bankruptcy risk are implemented in the banking systems?

Hypotheses:

To answer the main research question, the following three primary hypotheses are proposed, each consisting of four sub-hypotheses.

First primary hypothesis: There are no significant differences in the application of internal auditing principles.

First sub-hypothesis: Age does not affect the application of internal auditing principles.

Second sub-hypothesis: Qualification does not affect the application of internal auditing principles.

Third sub-hypothesis: Job position does not affect the application of internal auditing principles.

Fourth Sub-hypothesis: There are no significant differences in the application of internal auditing concepts attributed to the experience factor.

The second main hypothesis suggests that there are no significant differences in the implementation of bankruptcy risk reduction procedures.

The first sub-hypothesis states that differences in the application of these procedures are not significant based on age.

The second sub-hypothesis claims that qualifications do not lead to significant differences in the application of bankruptcy risk reduction procedures.

The third sub-hypothesis indicates that job position does not create significant differences in the use of these procedures.

The fourth sub-hypothesis asserts that experience does not result in significant differences in the application of bankruptcy risk reduction procedures.

The third main hypothesis posits that internal auditing does not significantly contribute to reducing bankruptcy risks at a significant level of 0.05.

The first sub-hypothesis under this main hypothesis states that the efficiency of internal auditors does not have a significant impact on reducing bankruptcy risks at the 0.05 significance level.

The second sub-hypothesis claims that the commitment of internal auditors does not play a significant role in reducing bankruptcy risks at the 0.05 significance level.

The Study Significance

This study emphasizes the critical role of internal auditing in the banking system. It demonstrates how these audits can help banks address various risks, particularly the risk of bankruptcy**.** The significance of this paper stems from the significance of its topic as:

- It is essential for creating value by helping the institution evaluate control risks.
- It aids in understanding the institution's current status by pinpointing strengths and weaknesses, allowing for actions to prevent bankruptcy.
- It underscores the benefits of implementing internal auditing practices in small and medium-sized enterprises.
- It stresses the importance of internal audits in an institution and their role in protecting and ensuring long-term sustainability**.**

Methods of the study:

This paper adopts the descriptive method to study the theoretical chapter as it is an appropriate method for the subject, and the analytical method is used to study the field part through a questionnaire. The SPSS program was used as a tool that helps us in analysis.

The study concepts

Auditing

The Institute of Internal Auditors, commonly referred to as IIA, provides a comprehensive definition of auditing, describing it as an independent evaluation process that is systematically established within an organization. This process is designed to thoroughly review various aspects of accounting, financial practices, and other operational functions to effectively support management in their decision-making processes. Auditing serves as a critical method of administrative control that is especially focused on the evaluation and measurement of how well other control mechanisms are functioning. By assessing these controls, auditing helps ensure that the organization operates efficiently and in accordance with established standards. This definition highlights the essential role that auditing plays in enhancing the overall governance and operational integrity of an organization. Auditing involves independently and fairly reviewing the financial information of any organization, no matter its purpose, size, or legal structure (Leung, Cooper, and Perera (2011). The American Federation of Certified Public Accountants describes auditing as a methodical way to collect and objectively evaluate evidence concerning financial statements and transactions. This process aims to determine how well these statements align with established standards and to share the results with interested parties.

Efficiency

Effectiveness and efficiency are crucial concepts that pertain to the degree to which established goals and objectives are accomplished, encompassing not only the completion of these goals but also their overall quality and impact. This principle is equally applicable within the realm of internal auditing. It is essential for internal audit functions to develop specific performance metrics and measurement criteria that are tailored to fit the unique characteristics and needs of their organization. This tailored approach will allow them to accurately assess how well they are achieving their defined objectives, with a strong emphasis on the quality of the audits conducted.

Bankruptcy

Bankruptcy serves as a public record that signifies a situation wherein an institution`s outstanding debts have surpassed its available assets. This condition is formally recognized as a legal declaration of insolvency and is documented by a court of law. The issuance of such a public declaration can engender a significant imbalance of information in the marketplace, which may subsequently lead to various economic repercussions. For example, the mere suggestion or indication of possible insolvency concerning a financial institution can trigger immediate and severe consequences, potentially culminating in the institution's bankruptcy. This phenomenon illustrates how critical the perception of financial health is, as it can have cascading effects not only on the troubled entity but also on other interconnected businesses and stakeholders. Consequently, the implications of a bankruptcy announcement extend far beyond the organization itself, influencing investor confidence and market stability as a whole (Dankiewicz and Szymańska, 2020).

Bankruptcy is thus a legal process designed to help businesses, individuals, and occasionally governments manage their financial difficulties. People or organizations file for bankruptcy when they cannot pay their debts on time or when their total debts are greater than their assets**.** Bankruptcies result from both internal (microeconomic) and external (macroeconomic) factors. Internal issues include the company's organizational structure, management practices, and access to financial information. Ineffective management can damage stakeholder relationships, leading to declining business performance in a harmful cycle.

Recent studies highlight a strong correlation between corporate social responsibility (CSR) initiatives such as environmental stewardship, community engagement, human rights commitment, and employee support and key financial indicators like market value and bankruptcy risk (Myšková & Hájek, 2019). Additionally, research on human capital management emphasizes that effective recruitment and retention of skilled employees are vital for financial success (Bilan et al., 2020).

The study Tools

This section presents the study sample, method, and variables.

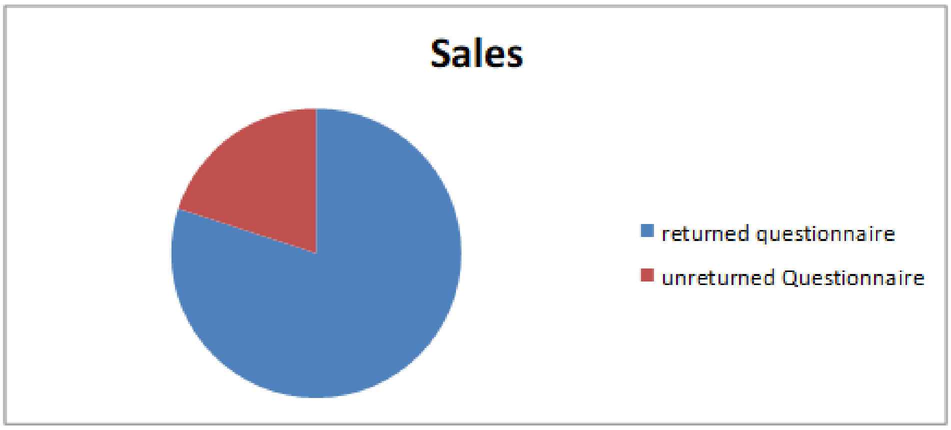
A- The study sample

In the city of Baghdad, a group of consulting employees, accountants, auditors, and university professors, participated in this study, where 40 questionnaires were distributed and 37 were returned.

Table No. 2: Statistics for the questionnaire

Survey	**Questionnaire Percentage**	
Number of questionnaires distributed	N.	Percentage
	40	100
Number of unreturned questionnaires	8	20
Number of returned questionnaires	32	80

Figure N. 1 shows the statistics of the survey



Prepared by the researcher

The Survey:

This sought to collect data from community members. A questionnaire was prepared and reviewed by auditing experts, making use of their feedback to correct errors and improve validity of the questionnaire. The final version consists of two parts:

1. Part One: Personal Information

2. Part Two: topic-related Information, comprising two Axes:

- **Axis 1: Efficiency and Commitment of the Internal Auditor (9 items)**
- **Axis 2: Procedures for Reducing the Risk of Bankruptcy (9 items)**

Participants completed the questionnaire using a five-point Likert scale, with options: Disagree, Neutral, Agree, and Strongly Agree.

B- The study Variables

The study examines the role of internal auditing in avoiding the risk of bankruptcy for banks, focusing on two key variables: internal auditing as the independent variable and bankruptcy risk as the dependent variable.

Part Two: the Questionnaire:

The researchers, after reviewing relevant scientific studies, concluded that organizing the questionnaire around these two main axes would effectively gather the necessary information.

- ✓ **The first axis: personal data: which includes age, certificates, job position, and experience.**

Table 2: Age variable of the study sample

Age	Frequency	Percentage
Less than 30	10	25%
From 30 to 40	15	37%
From 40 to 50	12	30%
More than 50	3	8%
Total	40	100%

Source: Prepared by the researcher based on spss.

- ✓ **The second axis: The auditor's efficiency and commitment**

This axis included a set of questions (8 phrases) to identify the auditor's competence and commitment, which are placed in one paragraph measured through 8 phrases.

- ✓ **The third axis**: Procedures to reduce the risk of bankruptcy

This axis included a set of questions (9 phrases) to identify the procedures that help avoid the risk of bankruptcy.

The study Reliability

The researcher conducted a number of tests on the questionnaire to ensure its validity, using expert arbitration, in addition to the necessary tests to verify its reliability, as follows:

1- Arbitration Reliability

The survey, based on previous studies and arbitrators' observations, was found to be free of scientific or methodological flaws and was adapted to the study's objectives. The survey, based on previous studies and arbitrators' observations, was found to be free of scientific or methodological flaws and was adapted to the study's objectives.

2- Internal consistency

The questionnaire's internal consistency was assessed on 40 individuals, who were asked to express their opinions on undefined phrases. Pearson correlation coefficient values were calculated between each statement and paragraph value, ensuring consistency.

- Internal validity of the auditor's efficiency and commitment axis are shown in table N.3:

N.	The statement	correlation coefficient	Significance Level
1	He evaluates and analyzes the documents submitted to.	0.749	0.00 0
2	He sticks to neutrality and integrity when performing his work.	0.814	0.00 0
3	He contributes to improving the bank's risk management, internal control and governance system.	0.734	0.00 0
4	He ensures that risk management is operating with the required efficiency and effectiveness.	0.746	0.00 0
5	He conducts an independent review of the control systems.	0.27	0.27 0
6	He reviews the key risk management process.	0.99	0.58 9
7	The reports he submits attest that the practice carried out in the bank follows the stipulated standards.	0.163	0.37 1
8	To support the independence of internal audit activities, performance should be reviewed by the Audit Committee.	0.250	0.16 7

Source: Prepared by the Researcher

The table shows a strong correlation between the phrases of the internal auditor's efficiency and commitment axis, with a correlation coefficient ranging between 0.163 and 0.814. Each phrase is statistically significant at a significance level of less than 0.05, except for phrases (1, 2, 3, 4) that exceeded the level, indicating the validity of the phrases.

- Internal validity of the bankruptcy risk avoiding measures questionnaire:

The following table (4) shows the internal validity of the statements of the second axis: Procedures to reduce the risk of bankruptcy.

N.	The statement	correlation coefficient	Significance Level
1	He summarizes the findings, so that these findings include identifying the risks and the procedures that must be followed to avoid them.	0.873	0.00
2	He estimates the risks leading to bankruptcy via studying and evaluating the internal control system	0.882	0.00
3	Auditing the financial aspect, clarifying the true financial position of the institution and supporting it with recommendations to avoid falling into financial difficulty.	0.861	0.00
4	Through the auditing process, the auditor discovers errors and fraudulent operations that occur within the bank.	0.855	0.00

5	Auditor's discovery and analysis of the risks that threaten the bank is a step that can protect the institution from bankruptcy.	0.795	0.00
6	The auditor evaluates the effectiveness of risk management and contributes to its improvement.	0.797	0.00
7	The internal auditor relies on the results of studying the internal control system of this bank to build the appropriate plan for work.	0.844	0.00
8	Risk assessment is an important step to address the risks that threaten the bank.	0.790	0.00

Source: Prepared by the researcher

The table shows a strong correlation between the statements of the axis of bankruptcy risk reduction procedures, with a correlation coefficient ranging between 0.790 and 0.882. Each statement is statistically significant at a significance level of less than 0.05, indicating that the statements are valid for their intended purpose.

Discussion and Results

The study hypothesizes no significant differences in sample members' perception of internal auditing concepts at a 5% significance level, with subsequent sub-hypotheses dividing the findings.

To test the first main hypothesis, there are no significant variations among sample members in perceiving internal auditing concepts at a 5% significance level. Sub-hypotheses were divided, with the first sub-hypothesis attributed to age. The analysis of variance was conducted as shown in the following table (5).

ANOVA	Total Sum of Squares	**Degree of freedom**	**Mean of squares**	**f**	**Sig.**
Between-Group Sum of Squares – SSB	**0.203**	**3**	**0.068**	**0.093**	**0.963**
Within-Group Sum of Squares – SSW	**20.332**	**28**	**0.726**		
Total	**20.535**	**32**			

The previous table shows that the sum of squares between the groups is 0.203, the F value is 0.093, and the significance level is 0.963, which is higher than the 0.05. This shows that there are no significant differences in how the sample members perceive internal auditing concepts, based on age, at a 5% significance level.

Internal audit aims to improve administrative decisions for better performance, particularly in oversight roles that protect the institution from potential risks. This makes internal audit essential for the organization. Internal auditors assess various functions to safeguard the institution's assets, ensure the accuracy of information exchanged, and identify any errors or manipulations that indicate weaknesses in the internal control system. They then propose solutions to address these weaknesses and enhance the system's effectiveness. Banks are particularly vulnerable to risks, such as bankruptcy, making internal audit a crucial resource. Audit reports provide valuable recommendations and solutions that help improve the control system and support management's decision-making process to mitigate risks. This study tested specific hypotheses and yielded the following results:

The study found no statistically significant differences in the application of internal auditing concepts related to age, qualifications, job roles, or experience, all at a significance level of 0.05. This indicates uniformity in responses regarding the implementation of internal auditing practices. Furthermore, there were also no significant differences in the use of bankruptcy risk reduction procedures related to age, reinforcing the consistency in responses.

No significant differences exist in bankruptcy risk reduction procedures based on qualification, job, or experience at a 0.05 significance level, indicating homogeneity in responses among sample members. However, there is a significant relationship between auditor efficiency and commitment in reducing bankruptcy risks. Internal audit plays a crucial role in protecting assets, ensuring information integrity, and activating control systems. The internal auditor's efficiency instills confidence in senior management decisions, helps detect errors and fraud, evaluates financial statements, and serves as a vital tool in institutional decision-making.

Recommendations:

The researcher recommends that management must consider auditor recommendations in decision-making. In addition, auditor suggestions should be evaluated to improve the internal audit system. Also, prioritization of the internal control system's effectiveness is essential. auditing should be incorporated into all functions to avoid risks. Finally, employee efficiency and skills in the control body should be emphasized.

Conclusions:

This study points to several areas for further research:

- Examining internal audit's role in evaluating internal control systems.
- Investigating how internal audits can improve job performance.
- Analyzing internal audit's influence on administrative decisions.

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