

A Theoretical Discussion of Internal Audit Effectiveness in Kuwaiti Industrial SMEs

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Abstract This paper aims to scrutinise the association between the internal audit effectiveness and the four factors associated with International Standards for Professional Practice of Internal Auditing (ISPPA): independence of internal auditors, scope of internal auditors, management support, and audited cooperation. The relationship between these factors and Satisfaction of internal auditors is also examined. Further, the moderating effect on the relationship between these factors (if present) and the effectiveness of IA among industrial SMEs in Kuwait are investigated through satisfaction of internal auditors. By ascertaining the effectiveness of IA at the industrial firms via theories as well as variables, this paper broadens the available literature on the effectiveness of IA.

Key words Internal audit effectiveness, satisfaction of internal auditors, Kuwaiti Industrial SMEs

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1. Introduction

Within the past few decades, internal audit departments have significantly contributed to organizational structure through value added services and thus, it has become crucial part therein (Al-Twajry *et al.*, 2003; Arena and Azzone, 2009; Coram *et al.*, 2008). Moreover, internal auditing has significantly increased in importance in the previous years, particularly in its consulting role inside the firm's risk management. Owing to the widespread accounting scandals, and also the bankruptcy of firms, the internal audit (IA) function has been the focus of researchers and practitioners alike as a significant contributor of organizational effectiveness. More specifically, Abu-Azza (2012) contended that IA will contribute firm value through the provision of field services including operational audits and consulting management on various issues. Following the global financial crisis in 2008-2009, IA has transformed into a significant entity used to protect the rate of return on capital and to prevent wasted or devalued capital (Yee *et al.*, 2008). Nevertheless, some studies in literature indicated that the effectiveness of IA function may not always be consistent (Abuazza *et al.*, 2015). This is particularly true in developing countries, like Kuwait where firms may not be aware how much the IA concepts and practices are worth as acknowledged in the West.

Moreover, Kuwaiti listed firms operate in an environment characterized with voluntary governance as Kuwait is considered to be among the Middle Easter nations that have not established a corporate governance code (Koldertsova, 2011). Moreover, such firms display high ownership concentration that may balance the weaker legal protection provided (Abu-Azza, 2012). Contrary to majority of developed nations, the Kuwait government mandates the appointment of a least two distinct auditors in firms, that are known as joint auditors or audit pairs. Despite the increasing importance of the IA function in organizations, the available literature in the domain has largely concentrated on external audit; other related authors indicated that IA function may not demonstrate consistent effectiveness (Al-Twajry *et al.*, 2003; Mihret *et al.*, 2010; Mihret and Yismaw, 2007). More importantly, although some scholars examined IA effectiveness, as yet, there is no accepted universal guide to conduct such measurement (Arena and Azzone, 2009). Additionally, the literature reveals that no acknowledged approaches have been forwarded for the assessment of IA (Mihret *et al.*, 2010) and as such, various approaches have been used in prior investigations of IA effectiveness.

To begin with, a study by Haniffa and Cooke (2002) focused on the effect of environmental factors on IA practice, while Al-Twaijry *et al.* (2003) and Yee *et al.* (2008) employed the ISPPIA formulated by IIA to guide their investigation and determination of IA effectiveness. On the other hand, Elliott *et al.* (2007), Mihret and Yismaw (2007) as well as Arena and Azzone (2009) each formulated a model for ascertaining the effectiveness of IA. As shown by these authors, IA effectiveness appears to be impacted by the contexts of its operation.

The importance of IA has been stressed by several academic studies like Al-Twaijry *et al.* (2003), Arena and Azzone (2009), Mihret and Yismaw (2007) and Yee *et al.* (2008) who urged for further studies and comprehensive research on the effectiveness of IA. In the context of developing countries, this feat could contribute to minimizing the literature gap. Also, extant studies in literature, as mentioned, have utilized different IAE measures like the application of internal audit recommendations (Arena and Azzone, 2009), or the adherence to International Standards for the Professional Practice of Internal Auditing (ISPPIA)(Al-Twaijry *et al.*, 2003; Mihret *et al.*, 2010; Mihret and Yismaw, 2007).

In the aforesaid background, there has been criticism towards ISPPIA with respect to its entire focus on performing the procedures without considering the outcomes in light of the principal stakeholders' requirements (Lampe and Sutton, 1994). Moreover, 15 criteria were underlined to contribute to IAE by Lampe and Sutton (1994) categorized under planning, fieldwork, as well as reporting and review.

According to Albrecht *et al.* (1998), management support is deemed to significantly affect the effectiveness of IA and such notion is supported by Mihret and Yismaw (2007), and Mihret and Woldeyohannis (2008) by claiming that management support determines IA effectiveness and is among the factors that positively contribute to the IA department (Mihret, 2010). Albrecht *et al.* (1998) further explained that, the evident support demonstrated by top management of IA becomes the top significant factor that improves its effectiveness. Added to this, it is also indicated by IIA's Standards for Professional Practice of Internal Auditing (1100- Independence) that internal auditors require senior management and board's support in order to cooperate with auditees and work with autonomy (IIA, 2016).

Moreover, the level of awareness among employees as well as the management of the significance of effective IA may impact its effectiveness to add value to the firm. Despite the fact that IA has become known as an integral portion of the structure of the organization for its value-added service as mentioned by Al-Twaijry *et al.* (2003), Arena and Azzone (2009), Mihret *et al.* (2010) and Yee *et al.* (2008), in developing nations, employees and management still overlook the value of IE concepts and practices unlike their Western counterparts (Al-Twaijry *et al.*, 2003; Mihret, 2010).

In a related study, Arena and Azzone (2009) highlighted the characteristics of the IA team, audit processes and activities alongside the organizational relationships that impact the effectiveness of IA. Meanwhile, in the context of Ethiopia, Mihret and Yismaw (2007) made use of mixed interview and questionnaire method to determine organizational characteristics that enhance or detriment IAE. Their findings revealed that internal audit quality significantly affects IAE. On the other hand, with respect to organizational setting and auditee's attributes, they had minimal effects.

Similar to its predecessors such as Al-Twaijry *et al.* (2003), Albrecht *et al.* (1988), Arena and Azzone (2009), Mihret *et al.* (2010) and Mihret and Yismaw (2007), the present study employs the institutional theory of the circuit of industrial capita to examine the effectiveness of IA, where it specifically determines two factors groups as significant for such effectiveness. In prior studies (Cohen and Sayag, 2010), IAE is considered in reference to the function's ability to meet the auditees' needs – such studies aimed to gauge the satisfaction level of the auditees about the IA work. Other studies made use of indirect measures, particularly when measuring the level of endorsement of and action taken upon internal audit recommendations (Arena and Azzone, 2009; Mihret and Yismaw, 2007).

In a similar study, Dittenhofer (2001) advocated for extensive measures of the capacity of IA for assessing the auditees' goals and objectives in order to come up with remedies in case the objectives are not met. Evidently, this calls for the assessment of dimensions of the internal audit business activities that may be influential such as corporate performance. Other similar studies focused on the IAs ability to positively impact the corporate governance quality (Sarens and Abdolmohammadi, 2011) with the inclusion of the capacity to make sure that effective risk management and IA control processes are established. Nevertheless, only a handful of studies that have used direct economic conditions regardless of the

arguments that quality is a facet of effectiveness, while the cost associated with realizing the quality should be kept into consideration (Cashell and Aldhizer, 2002).

On the basis of the above reasoning, studies failed to take into account the interconnections between quality and cost, and consequently, only a portion of the notion of effectiveness has been highlighted. Despite the logic behind this argument, collecting authentic data on internal audit costs is quite challenging hence, the hesitance of researchers – this is regardless of the fact that auditees have sometimes ascribe an implicit concept of cost-effectiveness during their quality evaluation.

2. Internal Audit in Kuwaiti Industrial SMEs

SMEs are an integral part of numerous global economies particularly with respect to employment and their contribution to GDP. They have also played a significant role especially within certain GCC States including the United Arab Emirates (UAE). In UAE SMEs contribute to 30% of the overall GDP and 86% of the country's employment. Comparably, in Saudi Arabia, SMEs make up 28% of GDP. On the other hand, Kuwait was late to appreciate the key role that can be played by SMEs enterprises in the economy. The private sector and SME contributions to employment lack lustre, and the government currently employs about 85% of Kuwait's workforce (Alhabashi, 2015). However, Rampurwala and Marafi (2011), and Al Mutairi and Fayez (2015) suggested that, in Kuwait, local policies are fragmented and although several organizations see the benefit of SMEs in various sectors such as industrial, they are still in their beginning stages. This means that the launch of new industrial SMEs is likely to be weak, thus reducing their opportunity to contribute to the economy. In addition, Datta (2009) and Alhabashi (2015), point out that formal banks are usually loathed to lend to industrial SMEs because they suffer from failure to authenticate their information, such as accounting records and financial statements that reflect the efficiency and the capability of the project. Within the context of business market of Kuwait, 99% of firms consists of small and medium enterprises (SMEs) operating in the national economy institutions. Based on the distribution of SMEs in different sectors of Kuwait's economic sectors, 11.7% of such firms operate in the industrial sector, 4% in the agricultural sector, 51% in the trade sector, 16% in the service sector, 0.3% in the mining sector, and the remaining 17% in other community services and social services sector.

Internal auditing is about "adding value and improving an organization's operations." There has been an argument that such objectives are highly crucial the business environment today. In fact, all organizations around the world, industrial SMEs included, are exposed to unique challenges. However, there has been progress, particularly when taking into account the recent global crisis from the viewpoint of an internal audit (IA). Times of uncertainty provide IA leaders as well as their teams with unique chance in assisting their management and also their board of directors in comprehending their risks and establishing the controls that are needed for their SMEs to more effectively operate and enhance their gains.

The internal audit is experiencing development that is unique. The tools of control for development inside business organizations are considerably different in comparison to those used in traditional organizations in almost the entire twentieth century. Businesses today are knowledge-intensive and such orientation creates processes and theme that are very complex at the international level. Organization in terms of function has changed. Further, there is a need for oversight, and internal audit profession of support functions to administer these organizations and the backbone of business organizations (Maqableh, 2014). As such, within the industrial SMEs, it is less likely for the demand for internal audit to occur because industrial SMEs encompass business operation and organizational structure that is complex. The demand for audit for such firms is majorly due to external complexities and conflict of interests in the relationship between the principal and the agent (Shrestha *et al.*, 2011).

In Kuwait, industrial SMEs Law necessitates that the Kuwait Stock Exchange (KSE) listed companies to appoint two separate auditors to audit accounts. Additionally, this study shows the similarities and differences between audit services in the market in Kuwait and in other countries to enhance the knowledge of world economy that is increasingly interdependent with accounting and auditing. Besides that, knowledge of the economies of auditing could also be increased (Shammari *et al.*, 2008).

The experience that Kuwait has when it comes to auditing offers a different context since it is a developing nation with developing new democracy. Via the Ministry of Commerce, the government of

Kuwait regulates the accounting profession. Further, it is yet to be understood if there exists expectation gap in Kuwait; a situation that is different in comparison to Spain with growing gap and Britain with an extensive history of expectation gaps. In this matter, the case of Kuwait Investment Office (KIO) is an interesting proof of auditors' capacity in comprehending scandals' fallout and the way the fallout is managed by the profession. There is also chance to trace audit activity relating to the delivery of improved accountability and openness within the operations of leading Kuwaiti organization, industrial SMEs included. Also, the fall of KIO's Spanish investments will elucidate more on the role of the Audit Bureau, which is the public sector auditing body operating in Kuwait, that competes with the international audit firms in a certain manner (AlHusaini, 2000).

3. Theoretical Perspectives

In the context of IA research, the use of neoclassical economic theories like the agency theory (Adams, 1994) as well as the transaction cost theory (Spraukman, 1997) are not sufficient because they posit a developed a market economy environment characterized as having considerable transaction volume according to the economic development level throughout countries (Reed, 2002). Therefore, this confines the capacity of the theories to explain IA in extensive settings.

More specifically, the agency theory cannot be transferred directly to state-owned firms as the principal may be ambiguous in a sense that the public may not have a single united interest. It is thus challenging to ascertain the existence of any interest discrepancy that may exist between managers and the public at large. In this context, Mandel (1977) criticized the earlier version of agency theory proposed by Alchian and Demsetz (1972) based on the Marxist economics. Similarly, Watts and Zimmerman (1990) study indicated that neoclassical economics posts that the organizational phenomenon is directed by the pursuit of individuals of self-interest maximization. In other words, neoclassical economic theories do not provide sufficient potential to explain the development of IA in different settings (Mihret *et al.*, 2010).

Criticism of the above theories also stems from the institutional theories maintaining that individual behavior whether as product consumer or producer, cannot be delineated from the social context wherein the behavior occurs (Hula, 1984). Barley and Tolbert (1997) explained that the institutional theory acknowledges the significant value of cultural and social determinants as a significant impact upon the decision making (cited in Mihret *et al.* (2010)).

Based on this premise, Mihret *et al.* (2010) made use of the institutional theory proposed by DiMaggio and Powell (1983), particularly circuit of industrial capital. Institutional theories primarily function as the base for examining organizational phenomenon integrated in extensive social, political and economic environments (Mihret *et al.*, 2010). More importantly, they are capable of providing an insight into the IA practices as one element of organizational systems and shed light on the relationship between IA and the attainment of the objectives of the firms (Mihret *et al.*, 2010).

3.1. Internal Audit Effectiveness

IA it's important to have its effectiveness examined in order to evaluate the related value-adding potential (Mihret *et al.*, 2010). This is evident by the quality of performance of the firm that can display if IA function is doing its role. Also, the examination can motivate individuals/organizations to enhance their performance. In this background, two important tools were proposed to achieve managerial accountability in the process of policy-making, which are evaluation and auditing. However, as mentioned, academic studies of IA effectiveness are still few and far between although the relation to an IA paradigm shift is evident (Mihret *et al.*, 2010). Majority of studies of this calibre provided mixed findings and assessed IA effectiveness through varying methods. To begin with, Cohen and Sayag (2010) looked in IA effectiveness determinants through a proposed model consisting of six potential factors that could affect the effectiveness of IA. These factors include: quality of audit work, organizational independence, career and advancement, and top management support. Further, they added that the effectiveness of IA is a crucial conception that has been understudied by researchers and in a few studies dedicated to it, and the concentration is mostly laid on external auditor as opposed to the internal auditor.

Cohen and Sayag's (2010) findings showed high correlations between top management support perceptions and IA effectiveness – in that perceived importance of top management support is considered

high. They also found positive relationships between higher auditing quality, organizational independence and IA effectiveness but none between professional proficiency, career advancement and effectiveness of auditing. The authors recommended future studies to integrate organizational independence and auditing work quality as determinants of IA effectiveness.

Moreover, in the study conducted by Mihret *et al.* (2010), the authors made use of the institutional theory and Marx (1978) theory to develop hypotheses and they recommended a research plan to examine the antecedents and IA effectiveness's organizational performance implications. Similarly, Al-Twaijry *et al.* (2003) utilized ISPPA adherence as an indicator of IA effectiveness, where such adherence represents the normative standards (IIA) that internal auditors are mandated to come next. The authors added that the dynamics within an IA environment affect its effectiveness. Also, the level of audit's compliance with ISPPA could be adopted as an additional method for its assessment and thus, empirical testing should exclude the hard-core positive approach or exclusive concentration on the agency theory (Al-Twaijry *et al.*, 2003).

In another related study, Arena and Azzone (2009) related that because of the current changes in the IA role, it is important to determine the organizational drivers of IA effectiveness and accordingly did so in the context of Italian firms. They showed that the significance of IA has been increasing throughout the years, particularly in recent times owing to its relationship with the internal control-risk management system. Further, they introduced a model for the measurement of IA effectiveness, where IA effectiveness was the dependent variable and the following were the independent variables; resources and competencies of internal audit, audit processes and activities, and the interaction level between IA and audit committee. They found internal auditors to be in need of new skills so that they can engage in activities that are directly linked to risk management and control, particularly to handle risk sources, and to enhance manager's confidence in managing and controlling risk. The study outcomes also showed that effectiveness of IA is impacted by its characteristics, audit processes and activities and organizational links. The authors claimed that internal audit (IA) effectiveness increases following the increase of ratio between the number of internal auditors and employees. Further, the CEO is linked to the Institute of Internal Auditors, the company uses control risk self-assessment methods, while the audit committee takes part in the activities of internal auditors (p.43). The authors also underlined the requirement for an in-depth analysis of the internal auditor's competencies to determine the exact skills that can impact their work.

To reiterate, researcher concerning the IA effectiveness area have been largely overlooked, and the findings of a few studies showed that IA function may not always function effectively. This chapter's discussion indicates that no specific standards or evaluation method of IA effectiveness exist and prior studies of this caliber provided mixed findings, and varying methods of assessment.

4. Research Model and Hypotheses

King *et al.* (1994) illustrated a model to be an approximation, or a straightforward replica of the actual feature and in the current study. The primary objective is to investigate the present perceptions of IA directors, administrative affairs managers, financial affairs managers, CEOs and internal auditors concerning IA effectiveness through the determination of factors impacting the same. Additionally, several studies that examined this issue have employed various measures (Abu-Azza, 2012; Mihret *et al.*, 2010; Mihret and Yismaw, 2007) but very few of them, as yet, has investigated the effect of internal auditors' pay satisfaction on the effectiveness of IA. Five variables exist in the Model: Independence of internal auditors, Scope of internal auditors, Management support, Audited cooperation and Satisfaction of internal auditors. Validated by the literature review, the chosen constructs selected are crucial in providing knowledge and clarification of the decision of industrial SMEs on internal auditor effectiveness in Kuwait.

Independent variables

This study aims to explore the critical factors influencing internal auditor effectiveness among industrial SMEs in Kuwait. In order to attain the research goals, the research hypotheses are proposed:

1. Independence of Internal Auditors

One of the factors that may influence effective audit activities is independence and objectivity of auditors as this would enable the completion of auditing sans interference. Independence and objectivity of

internal auditing in terms of assurance services and consultations are both importance and are closely linked to the freedom from interference on objectivity and compromise while auditing (All, 1999). In regards to this, the audit activity has to be independent from the entities requiring audit so no interference will influence the ability of the auditor to work objectively (All, 2001). The importance lies in the auditor's access of relevant documents without being wary or fearful, and in turn, this would lead to an objective report that is characterized by professional judgment and integrity. Auditor independence is promoted if the auditors are not acting in a capacity that is equal to an employee or a member client (Caplan and Kirschenheiter, 2000). In some instances, there is ambiguity in IA's role considering that internal auditors also belong to the management team while at the same time, these auditors are obliged to autonomously assess the effectiveness and efficiency of the management.

More recently, there appears an increasing interest on the issues related with independence and objectivity in internal audit processes as this could impact the internal audit's effectiveness – this underlies the fact that while the internal auditor is inclined to act to the best interests of the employer, he is still wary of going against management, notwithstanding the outcome (Sarens and De Beelde, 2006).

Moreover, in terms of audit function, auditor independence has long been deemed to be a crucial driver as evidenced by the independence definition provided by ISPPA (glossary) that described independence as the liberation from circumstances threatening objectivity or its appearance and that such objectivity needs to be managed through different levels (individual auditor, engagement, functional and organizational). Internal audit independence is a crucial element of corporate governance and the control system, and without it, the IA department becomes lost in the management group in that it will no longer provide an objective point of view (Al-Twaijry *et al.*, 2003). Moreover, internal audit independence according to prior studies (Abu-Azza, 2012; Cohen and Sayag, 2010; Mihret *et al.*, 2010), positively correlates with perceived effectiveness of IA. Regardless of its importance, independence of IA has received minimal attention from researchers. Accordingly, this study enriches the findings of the earlier studies as it looks into the association between internal auditor independence and IA effectiveness. Based on this discussion, the following hypothesis is proposed for testing;

H1a: *Independence of internal auditor positively impacts internal auditor's effectiveness.*

H1b: *Independence of internal auditor highly positively impacts internal auditor's effectiveness mediated by satisfaction of internal auditors.*

II. Work Scope of Internal Auditors

The work scope of the internal auditors is also a significant factor affecting IA effectiveness. IA throughout the years, has extended from the evaluation and measurement of internal control effectiveness to the delivery of consultation linked to organizational operations and system developments (Dittenhofer, 2001). Added to this, the IA scope covers services associated with consulting and assurance which include systematic review, reporting and appraisal of system adequacy in terms of finance, management, operations and budget control (Cohen and Sayag, 2010; IIA, 2016; Sakour and Laila, 2015).

In a related study conducted by Mihret *et al.* (2010), the authors revealed a positive relationship between IA work scope and IA effectiveness and as such, it is only logical to examine such relationship in this research in the context of Kuwaiti firms.

H2a: *Work Scope of Internal Auditors impacts positively on internal auditor's effectiveness.*

H2b: *Work Scope of Internal Auditors highly positively impacts internal auditor's effectiveness mediated by satisfaction of internal auditors.*

III. Management Support

Management support and commitment have also been evidenced to impact IA effectiveness. In fact, successful IA function depends on the support demonstrated by the management on the process of auditing. It is important that managers acknowledge the fact that IA is a crucial process and activity like any other activities performed within the organization. IA audit process is likely to fail with resource (money and time) wasted without management commitment. According to Md Ali *et al.* (2007), IA within the context of state and local government of Malaysia directly relate to management style and their

connections, relationships, and position in the social contract. In this regard, certain function of IA was found to be doing well, with the determinants include attitude and leadership qualities of management and audit reports; factors that have been paid minimal attention by studies (Md Ali *et al.*, 2007).

In Mihret and Yismaw (2007) study, they highlighted the need to focus on IA recommendations and despite the well-prepared audit reports, the audit results in the past are not highlighted and consistently presented. Aside from this, the authors showed that audit evidence is linked with the reports indicating that the audit reports are physically bulky, which minimizes their readability. Also, the distribution of audit reports is restricted and thus, copies are not forwarded to senior management officers that relate to them. The authors reached to the conclusion that management support for internal audit determines internal audit effectiveness.

H3a: *Management Support impacts positively on internal auditor's effectiveness.*

H3b: *Management Support highly positively impacts internal auditor's effectiveness mediated by satisfaction of internal auditors.*

IV. Audited cooperation

In turn, auditee's cooperation level impacts the degree to which IA properly attains its objectives (Al-Twajjry *et al.*, 2003; Mihret and Yismaw, 2007). Hence, auditee's lack of cooperation can possibly obstruct the endeavour in attaining effective internal audit work. This is because full cooperation from auditee is necessary to allow internal auditors full access to all activities, records and properties (Ahmad *et al.*, 2009). Within the companies in Saudi Arabia, Al-Twajjry *et al.* (2003) found low levels of auditee cooperation. This is especially true when the scope of audit is expanded outside of the traditional domains. Such situation, as argued by the authors, contributes to low levels of IA recommendations' implementation.

H4a: *Auditee cooperation impacts positively on internal auditor's effectiveness.*

H4b: *Auditee cooperation highly positively impacts on internal auditor's effectiveness mediated by satisfaction of internal auditors.*

Satisfaction of Internal Auditors as a Moderating Variable

The pay satisfaction of employees is described by the level to which employees feel satisfaction towards financial rewards they obtain in terms of the level and process for the work they do (Shahnawaz and Jafri, 2009). It is one of the top crucial factors that measure the effectiveness of the organization (Heneman *et al.*, 1997). Organizations having satisfied employees appear to display more effectiveness compared to their counterparts with dissatisfied employees (Shahnawaz and Jafri, 2009). In a narrower context of internal auditors, Shahnawaz and Jafri (2009) stated that majority of internal auditors were not satisfied with their jobs. This could result in lower productivity and performance. Abu-Azza (2012) supported this claim by his findings that showed the majority of internal auditors working for Libyan public enterprises appear to be dissatisfied with their pay.

H5: *Satisfaction of Internal Auditors impacts positively on internal auditor's effectiveness.*

5. Conclusions

The aim of this research proposal is to look into the impact of the four factors that are linked to IA effectiveness moderated by satisfaction of internal auditors within the Kuwaiti industrial SMEs. This study contributes in the body of knowledge by expanding the already available literature on the IA effectiveness via the determination of the effectiveness of IA at the industrial firms employing the theories and variables that were previously identified and highlighted.

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