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The Impact of Internal Audit Effectiveness on Public Sector Governance

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Abstract

The public sector plays a crucial role in attaining novel development objectives through its responsibility to ensure the efficient and transparent utilization of financial and technical support. Implementing effective governance practices within the public sector can enhance the overall well-being of citizens and foster more confidence in the government's capacity to administer public resources proficiently. In order to promote accountability and enhance the efficiency of public governance, internal auditors must evaluate the internal control system. Furthermore, it can enhance public sector governance by ensuring that the Chief Audit Executive (CAE) and internal auditor are affiliated with the Institute of Internal Auditors (IIA). This study aims to examine the influence of internal auditor competency and the efficacy of the internal control system on public governance. The study found a strong correlation between the effectiveness of the internal control system ($r = 0.761$) and internal audit effectiveness with a significant level of ($P < 0.01$). Additionally, there was a moderate positive correlation between the competence of an internal auditor and internal audit effectiveness with $r = 0.539$. The findings demonstrate a statistically significant and favourable association between internal auditors' proficiency and internal control systems' effectiveness, resulting in enhanced governance within the public sector.

Keywords: Internal Audit Effectiveness, Competence, Internal Control System, Governance, Public Sector.

Introduction

The notion of "governance" has existed since human civilisation's inception (Escap, 2009). According to Pratiwi and Sari (2017), the World Bank has defined governance as the utilisation of authority to effectively oversee economic and social resources to foster social progress. The World Bank has underscored the significance of resource management by governments in fostering community development. In contrast, the definition of governance provided by the United Nations Development Programme (UNDP) encompasses utilising mechanisms by political, economic, and administrative authorities to effectively supervise and regulate the many activities undertaken inside a nation, spanning across all levels. The United Nations Development Programme (UNDP) emphasises examining and enhancing the political, economic, and managerial dimensions of state administration. Political governance refers to the systematic development and implementation of policies and strategies. According to Khalid, Alam, and Said (2016), governance can be defined as the systematic decision-making procedure and subsequent implementation of those decisions. The application of governance can be observed across several contexts, encompassing corporate, international, national, and local spheres.

Although experts have provided several definitions, most agree on several essential components that signify a fundamental comprehension of governance. According to Gisselquist (2012), the fundamental elements encompassed within this concept are (1) the methodology or approach by which (2) power or authority is implemented, and (3) the administration of the collective matters of a community, country, society, or nation. The limited scope of governance definition allows for different interpretations of how power may be used and towards what ends it may be exercised within the society. For instance, it may be decided upon by a majority vote or by way of agreement, following a body of generally accepted rules, by the orders of a supreme leader, or by use of force. The government is one of the leading players in governance (Escap, 2009), while the other players rely on their status within the government. Depending on the level of government being discussed, various players may participate in governance, such as rural regions where prominent landowners, small-scale farmers, cooperatives, NGOs, research organisations, religious leaders, financial institutions, political parties, and the military are involved.

In addition, good governance is a concept that promotes ethical and transparent administrative conduct while discouraging unethical or questionable actions. (Bouckaert & Van de Walle, 2003). The connection between public authorities and citizens is based on shared values and principles. (Bhuiyan & Amagoh, 2011; Kalsi et al., 2009). Successful governance relies on the ethical conduct of public service, with accountability being an essential aspect. Accountability is always linked to good governance (Bhuiyan & Amagoh, 2011; Morrell, 2009; United Nations Human Rights, 2012). Public organisations must participate in managing public funds, conducting public business, and upholding fundamental human rights. This means that the government's administration should be free from human rights abuses and refrain from illegal actions that may lead to corruption.

Governance in the public sector refers to ensuring accountability for achieving specific goals related to service delivery and policy effects on the community (Alqooti, 2020). Ronald (2013) claims that the concept of accountability in the public sector comprises several dimensions, depending on the scope of the interaction between the public institution and other parties (internal and external stakeholders). Public entities should use specific mechanisms to ensure external accountability and compliance, such as annual reporting based on standards and principles and preparation of audit reports. Effective internal audits are essential to improve transparency and accountability in the public sector.

Problem Statement

Governance is a management tool that significantly affects an organisation's performance (Prihanto & Gunawan, 2020). According to Hopper (2017), neopatrimonialism, which includes corruption, collusion, and nepotism, can impede the progress of the government's development. According to Blackburn and Forgues-Puccio (2009), poor government law enforcement and bad governance are the root causes of both lousy governance and corruption. According to the Corruption Perception Index (CPI) in 2022, the most corrupt Islamic country is Iraq, where the CPI score is only 23, followed by Indonesia, Oman and Malaysia (refer to Table 1).

Table 1
Corruption Perception Index (CPI) Among Islamic Countries in 2022

Rank	Countries	CPI Score
1	Iraq	23
2	Indonesia	34
3	Oman	44
4	Malaysia	47
5	Arab Saudi	51
6	United Arab Emirate (UAE)	67

Prihanto and Gunawan (2020) reported that corruption cases in Indonesia mainly derived from poor governance, poor leadership, and poor utilisation of information technology. On top of that, research conducted in the United Arab Emirates (UAE) revealed that the cause of corruption cases due to the ineffective law enforcement by the government (Ali, 2022). According to Pentra Fraud Theory (also known as Crowe's Fraud Pentagon Theory), the reasons for corruption (fraud) are competence, opportunity, pressure, rationalisation, and arrogance (Crowe Horwath, 2011). Employees' competence or capability is their capacity to evade internal rules, devise cover stories, and manipulate social settings for their benefit. Being arrogant means feeling superior to others and thinking that rules and policies do not apply to you. To address this issue, it is essential to have an efficient internal auditor who can help eliminate corruption and improve public sector governance. Effective internal audits are essential for ensuring accountability and transparency in organisations.

Theoretical and Conceptual Framework

According to Joshi, Karyawati Purba (2022); Joshi (2021); Coetzee and Erasmus (2017), several theories (institutional theory, agency theory, and stakeholders' theory) have been used to explain or interpret in relation to the effectiveness of internal audit. Given that this research focuses on the internal auditor competency and the effectiveness of the internal control system, resourced-based theory was more suitable to address the related variables in explaining their relationship towards internal audit effectiveness which directly improves the public sector governance. According to Ahmad (2015), resource-based theory offers a convincing justification for the significance of uncommon and precious resources in aiding the formulation of methods that improve the performance of internal audit functions. As a result, this study underlines the importance of internal organisational resources (internal auditor competency) as one of the elements in determining how well an organisation performs (Barney, 1991). The environment, technology, size, organisational structure, strategy, and culture are some of the components of contingency theory (Chenhall, 2003). The effectiveness of the internal control system (control environment, risk assessment, activities control, information and communication, as well as monitoring), is a variable of the organisational structure. As a result, the effective functioning of internal control systems is a contingent variable that can improve the effectiveness of internal audit performance. In this context, an effective internal audit function (by recruiting competent internal auditor and having an effective internal control system) may improve the public sector governance in a way that is more transparent and highly accountable.

Public sector governance includes accountability duties with regard to achieving specified goals, including the effects of policies on the community as a whole as well as service delivery (Alqooti, 2020). The idea of accountability in the public sector is diverse and includes several aspects depending on how closely a public organisation is linked to other parties, both internal and external (Almquist, Grossi, Van Helden, & Reichard, 2013). In a similar vein, APEC (2011) stated that there are certain mechanisms public entities should use to guarantee accountability and compliance on an external level, such as yearly reporting by the norms and principles, and an audit of the financial statement. Figure 1 below illustrates the conceptual framework that is being used for this study.

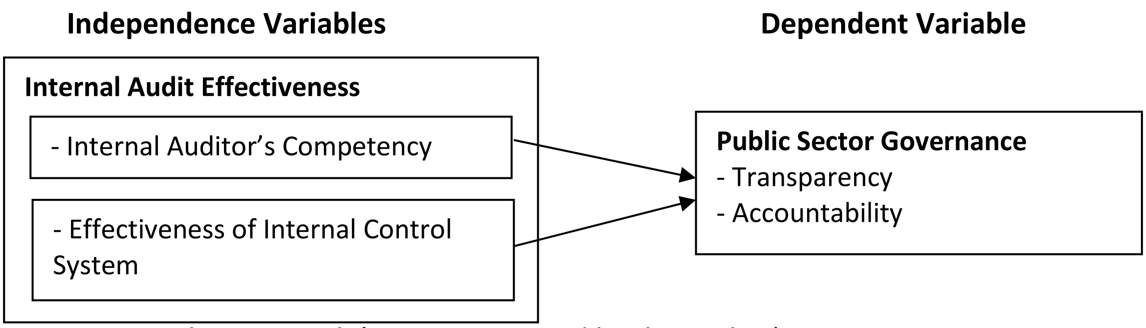

Figure 1 *Conceptual Framework (Source: Prepared by the Author)*

Internal Audit Effectiveness

Competence of Internal Auditor

Being a member of the IIA is a crucial aspect of an internal auditor's expertise. Burns et al. (1994) suggested that regulatory bodies could enforce clauses mandating organisations to appoint a Chief Audit Executive (CAE) who is either a Certified Internal Auditor (CIA) or an IIA member at the very least. Abdolmohammadi (2009) mentioned that the IIA membership was critical to the internal auditor's competency. IIA membership is one of the criteria that Al-Twaijry et al. (2004) and Arena and Azzone (2009) used to evaluate the competency of internal auditors. Coetzee et al. (2015) asserted that a rise in IIA membership may impact the quality of internal audits. According to earlier research, the duration of CAE's membership in the IIA impacts the use of and compliance with IIA standards (Abdolmohammadi, 2009; Abdolmohmmadi & Sarens, 2011). According to Alzeban (2015), being a member of IIA is crucial for ensuring that internal audits comply with IIA standards. Additionally, Arena and Azzone (2009) found that when the Chief Audit Executive (CAE) is an IIA member, more auditees tend to follow internal auditors' recommendations. Therefore, we expect that membership in IIA by both the CAE and internal auditors will positively impact public sector governance.

Having a professional certification is essential for those in the internal audit profession. The most common certification for internal auditors is the Certified Internal Auditor (CIA), offered by the Institute of Internal Auditors (IIA). Studies have shown that a professional certification indicates an internal auditor's competence, which in turn affects the effectiveness of their work (Endaya & Hanefah, 2016; Lin et al., 2011; Sarens, 2009). External auditors have also noted the importance of internal auditor competence, as they rely on internal audit work (Al-Twaijry et al., 2004).

Furthermore, the professional certifications of internal auditors have a significant impact on the compliance of internal audit functions with IIA standards (Abdolmohmmadi & Sarens, 2011), the accuracy of financial statements (Prawitt et al., 2009), the implementation of internal audit recommendations (Alzeban & Sawan, 2015), and the active role of internal auditors in public sector governance (Sarens et al., 2012). Based on these reasons, this study hypothesised that possessing professional certifications (demonstrating an internal auditor's competence) will positively correlate with improving public sector governance.

Hypothesis 1 (H_1): The competency of internal auditors is positively associated with improving governance in the public sector.

Effectiveness of Internal Control System

Many nations now consider establishing an internal control system necessary, as governance practices have become increasingly important (Almashhadani & Almashhadani, 2022). In the public sector, management control involves policies and practices that enhance organisational accountability (Asare, 2009). Internal control can be seen as a part of management control in this context. In the public sector, controls are primarily implemented in the Public Financial Management (PFM) system. The legal and organisational framework of PFM encompasses the oversight and regulation of several aspects, including budget preparation, internal control and audit mechanisms, procurement processes, monitoring and reporting systems, and external audits.

The primary objective of PFM is to foster fiscal discipline, prioritise resource distribution, and improve public service delivery. Internal auditors play a crucial role in the attainment of these objectives. Audit-related concerns are reported by individuals to senior management within public sector organisations, aiming to enhance public institutions' governance through suggestions. Figure 2 illustrates a comprehensive array of PFM concerns, encompassing control structures and accountability systems. These issues encompass strategic planning (including budgeting), managerial activities (such as procurement, public debt, and asset management), accounting and reporting, internal and external audits, and legislative oversight.

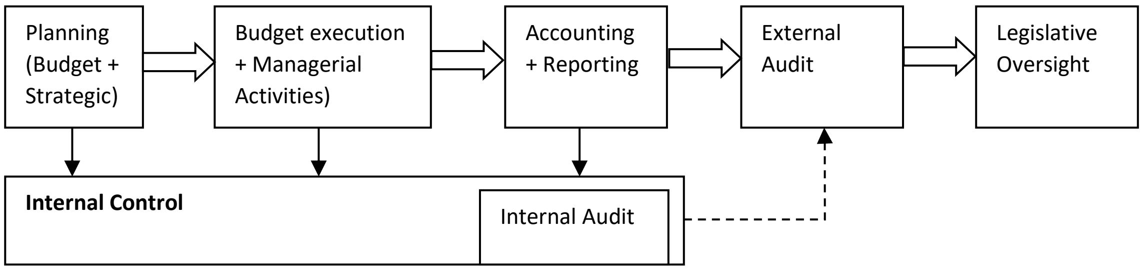

Figure 2 *Public Financial Management Cycle (Source: Baltaci & Yilmaz, 2006)*

To enhance accountability and efficacy, the internal auditor must fulfil their role in evaluating the internal control system. The internal auditor is one of the effective mechanisms to assess the degree to which the public institution provides services on time and high-quality services (Baltaci & Yilmaz, 2006). Internal audit activity has evolved into a tool for monitoring and assessing managerial operations before being externally evaluated by auditors. In the public sector, internal auditors collaborate with management to improve service delivery, strengthen internal controls, and ensure legal compliance. From the foregoing discussion, it is evident that the effectiveness of the internal control system is capable of improving public sector governance. The study therefore hypothesizes that:

Hypothesis 2 (H_2): The effectiveness of the internal control system is positively associated with improving governance in the public sector.

Public Sector Governance

The concept of governance emerged due to changes in government functions, the evolution of information and the need to redistribute duties among all stakeholders (Alqooti, 2020). This shift has resulted in a move from centralised to decentralised systems and from representative to participatory democratic systems. Public administration is now used to deliver new development agendas, ensuring financial and technical assistance achieves its objectives by applying governance principles such as transparency, accountability, and integrity According to the Australian National Audit Office (ANAO) in 2014, the public sector is varied and constantly changing. Therefore, government agencies must use effective management methods, improve their services, and be adaptable to achieve optimal efficiency and innovation while delivering new and unique services. Ace (2014) acknowledges that governance in the public sector is not as effective as in the private sector, and clear governance standards must be developed for the public sector. Specific actions and guidelines must ensure the proper application of governance principles. After the financial crisis in 2009, the public government was reported to take the stage, aggressively governing corrupt corporations (KPMG, 2010).

The evaluation of government's role in society and the increasing demand for accountability, transparency, and integrity have made public sector governance a crucial issue on both global and regional levels. To address this issue, various international institutes have developed frameworks for public governance that provide rules and principles for public entities to follow. Some frameworks that are relevant to public governance include IFAC's 2001 framework, the 2011 Good Practice Guide on public governance, the Institute of Internal Auditors' publication on the role of auditing in public sector governance, and the IFAC and CIPFA's international framework on good governance in the public sector.

The Concept of Good Governance

Establishing good governance is crucial for an effective and corruption-free government. Good governance, according to the World Bank, involves implementing strong management practices that align with democratic principles and efficient markets, preventing investment fund misallocation and corruption in political and administrative management, exercising budget control, and developing legal and political frameworks for business growth (Mardiasmo, 2002). Thus, good governance is a necessary foundation for a democratic political system and can drive political governance to improve citizens' welfare by formulating public policy, implementing development, and transparently operating public administration bureaucracy (Dwipayana, 2003).

To earn the trust of citizens, it is crucial to implement good governance principles in the public sector. CIPFA (2013) states that good governance in the public sector promotes sound decision-making, efficient resource utilization, enhanced accountability in resource management, improved public sector performance, and the prevention of corruption. Strong governance within the public sector ensures proper management of resources and promotes efficient resource utilisation (Juiz et al., 2014).

Malaysia is taking continuous action to enhance governance practices in the public sector, following the guidelines for good governance issued by the Chief Secretary to the Government (KSN) in March 2007. The circular PM (S) 17479/13 No. 4, 2007, titled "Enhancing Corporate Governance for in Public Sector" (Saidin & Ahmi, 2019), is being implemented. In 2009, Malaysia launched a Government Transformation Programme aimed at improving the public sector through six National Key Results Areas (NKRAs) (Khalid et al., 2016). This approach intends to make the government machinery more effective in providing services and accountable for the outcomes, thereby promoting progress, unity, and better living standards.

Several principles of good governance may influence the quality of public sectors (Aziz et al., 2015; Said et al., 2016). According to Escap (2009), there are eight major principles of good governance: participation, consensus, accountability, transparency, responsiveness, efficiency, equity, and adherence to the rule of law. In contrast, The National Centre for Governance, Integrity, and Anti-Corruption (2020) emphasises four primary principles of good governance: transparency, accountability, efficiency, and effectiveness.

Transparency

Transparency means making decisions and implementing them by laws and regulations (Escap, 2009). It also involves providing individuals who will be impacted by these decisions and their implementations with free and direct access to information. Furthermore, it entails presenting information in a way that is easy to comprehend. In the public sector, transparency refers to being open about the goals pursued by a public sector entity, the resources required or utilized, and the results achieved (CIPFA, 2013). The public sector organisation should be transparent and open to its stakeholders, including the general public, customers, and employees. Accountability reports should be produced and conveyed in a clear and accessible manner suitable for the audience. Public sector organisations may now reach their stakeholders through various platforms, including social media and web-based information. To meet transparency requirements while not being overly burdensome for the business or the recipient, the relevant quantity of information must be delivered through the proper communication channels.

The standards for accounting and auditing, as well as the financial reporting system, play a vital role in evaluating transparency in both the public and private sectors. Auditing is crucial to the functioning of businesses and forms a significant part of the foundation of modern economies (Zhuang et al., 2001). Investors would be hesitant to purchase shares of a company, banks would be reluctant to lend money to businesses, and the public would be unable to verify a company's financial health claims without the auditors' reports (Backman, 2001). Implementing widely accepted accounting standards will undoubtedly improve the quality of transparency (Singam, 2003). Public sector entities must demonstrate that they have fulfilled their stated obligations, requirements, and goals while efficiently utilizing the resources provided by the government (CIPFA, 2013). Thus, it is necessary for organizations to publicly report their operations at least once a year, so stakeholders can evaluate their performance, assess if they provide value for money, and determine if resources are used effectively. Moreover, the governing body and senior management need to take responsibility for the presented findings while collecting and preparing data for the annual report.

The Corruption Perceptions Index (CPI) is the most well-known indicator to assess the quality of transparency. The CPI is a survey of polls that captures the opinions of local and foreign businesspeople and experts of the nation. The CPI, first released in 1995, used 15 polls from nine independent institutes between 2000 and 2002. The CPI evaluates the extent of public sector corruption in 180 countries and territories globally. Scores vary from 0 (denoting high levels of corruption) to 100 (indicating very clean governance). Regrettably, more than two-thirds of countries have scored below 50, and 26 countries have received their lowest scores ever. Despite the efforts and progress of some nations, 155 countries have not made significant progress in tackling corruption or have even seen a decline since 2012. In 2022, 14 countries were judged to have exceptionally high levels of corruption with scores less than 20. Several countries, such as Somalia, Syria, South Sudan, Venezuela, and Yemen, have been rated as having high levels of corruption. However, eight countries have received a score of more than 80, indicating that they have low levels of corruption. These countries, including Denmark, Finland, New Zealand, Norway, and Singapore, have been given a 'clean score'.

Accountability

According to CIPFA (2013), accountability refers to the public sector's duty to be responsible for their policies, decisions, and actions towards other stakeholders, especially public finances. In order to ensure accountability, decisions and service delivery must be carried out by individuals who can be held responsible. Transparency and reporting on actions taken are important components of accountability, as they allow stakeholders to comprehend and respond well to an organization's plans and operations. However, accountability in the public sector is more complex and diverse than in the private sector due to the various responsibilities and objectives of both internal and external stakeholders (Australian National Audit Office, 1997). Figure 3 illustrates the chain of accountabilities for Departments, Statutory bodies, and Government Owned Corporations (GOCs) (Ryan, Dunstan & Brown, 2002).

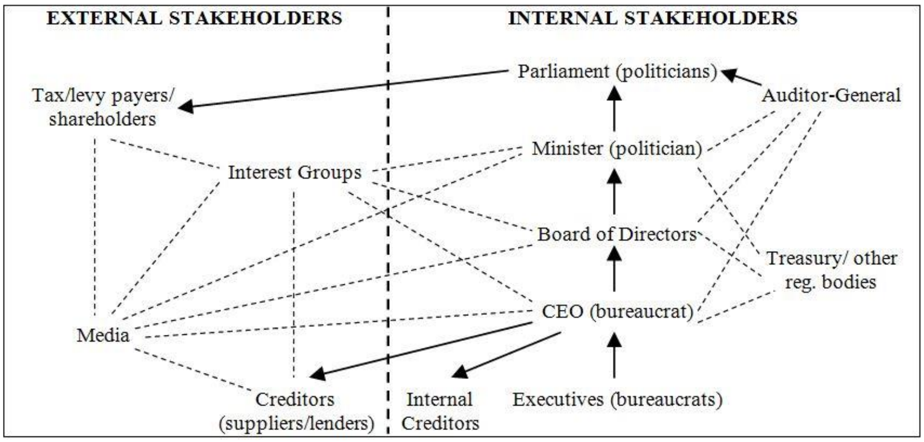

Figure 3 *Chain of Accountabilities for Departments, Statutory bodies, Government Owned Corporations (GOCs) (Source: Ryan, Dunstan & Brown, 2002)*

Figure 3 categorizes the board of directors, minister, treasury, and other governing bodies and the auditor general as internal stakeholders, as stated by Ryan, Dunstan, and Brown in 2002. On the other hand, external stakeholders include levy payers, interest groups, suppliers, and the media. Chee's research in 1991 concluded that the media serves as an external check-and-balance mechanism for public accountability. One way institutions demonstrate accountability to external stakeholders is by being responsive to public and media inquiries (Coy et al., 2001). Due to the wide range of shareholders, the public sector is held accountable to many sectors, necessitating high transparency and disclosure (Abu Bakar, 2013). Coy et al. (2001) contend that politicians, officials, or management need to be accountable to the public, which forces them to engage in open discourse that sometimes brings their actions into question and even serves as the basis for those actions. From here, it shows that public sector organisations should be liable to the public as a whole rather than only accountable to those at the top of the hierarchy.

Findings

Correlation Analysis

The results indicate that there is a significant positive correlation between the competencies of an internal auditor and the effectiveness of the internal control system towards internal audit effectiveness (refer to Table 2). The study found a strong correlation between the effectiveness of the internal control system ($r = 0.761$) and internal audit effectiveness with a significant level of ($P < 0.01$). Additionally, there was a moderate positive correlation between the competence of an internal auditor and internal audit effectiveness with $r = 0.539$. These findings suggest that both components play an essential role in improving the governance of the public sector by ensuring transparency and accountability.

Table 2
Pearson Correlations Matrix

	Competence of Internal Auditor	Effectiveness of Internal Control System	Internal Audit Effectiveness
Competence of Internal Auditor	1	0.607**	0.539**
Effectiveness of Internal Control System	0.607**	1	0.761**
Internal Audit Effectiveness	0.539**	0.761**	1

** Correlation is significant at the 0.01 level (2-tailed).

Conclusions

This research demonstrated how the internal audit function (internal audit effectiveness) supported good governance in the public sector. A substantial positive association were discovered between the competence of the internal auditor and the effectiveness of the internal control system towards the effectiveness of the internal audit. This is attributable to the existence of skilled internal auditors and the engagement of the internal auditors with management to improve service delivery, strengthen internal controls, and ensure legal compliance. Thus, this study concluded that internal audit effectiveness is a crucial element in fostering good governance and accountability in the public sector. The internal auditors are responsible for assessing the organisational controls, governance, and risk management procedures, and their services are relied upon by governing bodies for effective and efficient operations. Hiring competent internal auditors, including a Chief Audit Executive (CAE) with IIA membership, can improve public sector governance. In addition, the internal auditors must effectively assess the internal control system to improve accountability and effectiveness in public governance.

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