

Internal Audit's Impact on Malaysian Banking: Conceptual Framework with Management Support as a Moderator

Panjavarnam A/P Venugopal¹, Maisarah Mohamed Saat² and
Nik Nadzirah Nik Mohamed³

¹Azman Hashim International Business School, Universiti Teknologi Malaysia, ²Faculty of Management, Universiti Teknologi Malaysia, 81310 Johor Bahru, Johor, Malaysia, ³Razak Faculty of Technology and Informatics, Universiti Teknologi Malaysia

Corresponding Author Email: pnj_v3@hotmail.com

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Abstract

There have been continuous studies conducted on Internal Audit Effectiveness (IAE) for many years. Referring to literature regarding the concept, it was observed the area of research on the influence of management support and internal audit characteristics (IAC) namely objectivity, independence, effective communication, and competencies on IAE context remained underexplored in developing countries. Whereas, management support is tested as a moderator due to its significance, particularly in internal auditing. In addition, most studies conducted in Malaysia on IAE mainly focusing on public sector and very limited studies conducted on private sector setting. To answer the consequence of research gaps, this conceptual paper proposes the effects of objectivity, independence, effective communication, and competencies through management support as a moderator to measure IAE in Malaysia. Hence, this research use Agency and Contingency Theory. The conceptual paper focused on private sector banking industry in Malaysia. The research philosophy that will be adopted is positivistic approach to test the formulated hypotheses empirically. This research is expected to use quantitative analysis approach and survey strategy whereby an established measurement tools adopted for each construct is adapted in the conceptual model. The questionnaire results will be analysed using SPSS software.

Keywords: Internal Audit Effectiveness, Management Support, Objectivity, Independence, Effective Communication, Competencies

Introduction

The Institute of Internal Auditors (2010), stressed on the criticality of Internal Audit (IA) as a mechanism to control the governance and operation of an organization. Initially, the attention of IA function limited to compliance assurance, financial control and assets

safeguarding (Allegrini et al., 2006; Dellai et al., 2016). Nevertheless, due to increase in the regulatory requirements, governance, and risk management (Cohen & Sayag, 2010), the demand on IA has moved to on how IA will add value to the organizations (Allegrini et al., 2006; Erasmus & Coetzee, 2018).

The definition of IA has been further explained by Institute of Internal Auditors (IIA), which is being largely accepted as; *“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2017)”*.

IA performance is typically evaluated by making comparison between actual performance and the predefined objectives by taking into consideration on the measurement of accomplished efficiency and effectiveness (Beckmerhagen et al., 2004; Shu et al., 2010). Turetken (2019), quoted Arena and Azzone (2009), defined the term effectiveness as an ability to attain results which are constant with the targeted objective. Whereas, Dittenhofer (2001) defined the term as an accomplishment of an expected outcome. On the other note, efficiency signifies the extent an organisation maximises its resources in creating quantifiable outputs (Dittenhofer, 2001). In alignment with mutual understanding, effectiveness is doing the right thing, while efficiency is doing it well (Chambers, 1993).

Nevertheless, recent studies have argued the IA effectiveness is entirely dependent upon the senior management appreciation and the support channelled through internal auditing. Lenz and Han (2015), indicated that internal auditors can attain an appropriate resource to achieve IA responsibilities by senior management support or top management support. Senior management support has been one the critical factor that has been studied by various researchers such as Sarens and Beelde (2006); Sterck and Bouckaert (2006); Schneider (2008); Arena and Azzone (2009); Soh and Martinov-Bennie (2011); Lenz and Hahn (2015) which complements the current study.

Based on this background, the current study intending to examine the effect of internal audit characteristics, consisting of internal auditors’ objectivity, independence, effective communication and competencies on IAE. This research emphasises the criticality of internal auditor’s individual characteristics which is essential for IAE. In tandem, the International Standards for Professional Practice of Internal Auditing (ISPPA) also accepts these characteristics as attributes for both organizations and individuals (Institute of Internal Auditors, 2012). Whereby, this research will inspect management support as moderating variable on the above relationship.

Literature Review

This research aims to enhance internal audit function through identification of key drives which contributes towards the IAE. The researcher interested in finding out the extent of these drivers contribute to IA effectiveness in an organisation. Moreover, this research expected to reveal the extend of management support that contributed towards the IA effectiveness in banking sector in Malaysia.

The Role of Internal Audit

The effectiveness of internal audit resources which had been extensively been documented in the prior literature. Various researchers have highlighted some of the important drivers

which leads to the effectiveness of internal audit. This is inclusive of competencies of internal auditors consists of audit skills, finance, information technology and business risks (Arena and Azzone, 2009; Soh and Martinov-Bennie, 2011). Personal attributes of internal auditors such as experience, soft skills, personality traits (Prawitt, 2003; Van Peurse, 2005; Mirhet et al., 2010). Whereas, some researches have indicated that IA effectiveness is the results of combination of different factors such as internal audit quality, management support, organizational setting, qualities of the auditee, and the audit team competence, objectivity, effective communication and the IA independence (Mihret & Yismaw, 2007; Stewart & Subramaniam, 2010; Endaya & Hanefah, 2013; George et al., 2015).

Internal Audit Characteristics

Objectivity

Objectivity is defined in IIA standards as “unbiased mental attitude” (IIA, 2016), whereby code of ethics demands demonstration uppermost professional objectivity by internal auditors during audit activities. Internal auditors to gather, evaluate and communicate information and not to unreasonably influence by their own interest and or other’s in making judgements. There are three dimensions in objectivity which consist of impartial, unbiased and avoidance of any conflict of interest which to be uphold during executing duties by internal auditors (Institute of Internal Auditors (IIA), 2012; Brandon, 2010).

According to Schneider (2010), objectivity is an important factor of IAE. There are other few similar studies which have parallel opinion on the importance of objectivity for internal auditing (sarens and Subramaniam, 2010). The importance of objectivity at individual level is extremely crucial to ensure department level success in performing auditing work. In this study, the measurement of objectivity is based on self-assessment performed by internal auditors and the moderating effect of senior management support towards IAE. While, its dual role as consultant and assurance provider which expected to add value to an organisation (Jiang et al., 2019). Nevertheless, there are high risk of internal auditor’s objectivity is compromised which pose a threat of self-review, social pressure and familiarity (DeZoort, Houston, & Peters, 2001).

Hence, professional judgement expected not to demonstrate actual value if uncertainty or doubts arises on the internal auditor’s objectivity. Nevertheless, this study expects objectivity to influence the IAE. Thus, the following hypothesis is proposed: -

H1: Internal auditor’s objectivity is positively related to internal audit effectiveness.

Independence

Definition of independence is a freedom from conditions which threaten the capability of internal audit activity to perform internal audit responsibilities in an unbiased manner (Institute of Internal Auditors (IIA), 2012). Internal auditors will be able to execute its responsibilities in unprejudiced custom with freedom and relieve from a situation which impede their capability. The freedom, unrestricted and direct access of chief audit executive to senior management and board, confirms level of independence and its achievement in carrying out its duties comfortably to conduct auditing activities. This is attained through a relationship of double reporting. According to IIA (2012), threats on independence should be addresses and managed at various level including at auditor, during discussion, functional and organizational levels.

However, earlier research claim that absence of independence in several developing countries is a hindrance to carry out a satisfactory performance of an IA. This is as evident in the South African public sector which acknowledged on the absence of independence as an issue encountered by the internal audit function of the country as claimed by Schyf, 2000. Specifically concerns pertaining to lines of communication and reporting levels that had implications for independence. Other studies conducted by Brierley et al (2003) (Sudan); Mulugeta (2008) (Ethiopia); Ahmad et al (2009) (Malaysia) in developing countries which stressed on absence of independence and the effect of internal audit department's strength. Internal audit function independence is expected to improve quality of financial reporting (Dezoort et al., 2002; Ege, 2015) and internal control efficiency Fadzil et al (2005) that enhances the efficiency of the firm's operation (Biddle et al., 2009; Cheng et al., 2018).

Thereby, independent is a desired characteristic for an internal auditor to provide assurance services performed as an individual or team which are free from material conflicts of interest that threaten objectivity. Hence, this study expects objectivity to influence the effectiveness of internal auditing. Thus, the following hypothesis is proposed: -

H2: Internal auditor's independence is positively related to internal audit effectiveness.

Effective Communication

Quality of communications is described to be accurate, objective, clear, concise, constructive, complete and timely (ISPPIA, 2016). Whereas, norms of communication must include engagement objectives, scope, conclusions, recommendations, and action plan (ISPPIA, 2016).

One of the significant factors which determine the auditors' effectiveness is an effective communication that is accessed by exploring the association with auditees who is member of an organisation. Internal auditor who adopts accusatory type of audit or scrutinizing the auditees weaknesses will instigate distrust between auditees and internal auditors which eventually affect effective communication process between both parties (Hahn, 2008).

According to Kyburz (2016), further in-depth research to gain better knowledge on the communication between IAF and other stakeholders such as management as a representative for management which will be a fruitful research field, that has not been thoroughly explored. Whereas, Boyle et al (2015), suggested that further research is required on the communication of internal auditors, that emphasize the report types and their ability of making judgement an influencing governance member.

Effective communication is an essential skill possessed by auditor's which contributes to IA effectiveness. Hence, this study expects objectivity to influence the effectiveness of internal auditing. Thus, the following hypothesis is proposed: -

H3: Internal auditor's effective communication is positively related to internal audit effectiveness.

Competencies

According to Arens et.al (2014), competence is defined as a knowledge and skills possessed to accomplish tasks assigned to an individual. Whereas, Singgih and Bawono (2010) define due professional care as precision and accuracy as part of the professional skills that necessitate the auditor to perform professional duties. The meaning of due professional care is defined as careful and thorough professional skill (PSA No. 04 SPAP 2001). According to

Institute of Internal Auditors (2016), which asserted that auditor must adhere to the requirements as guided in the professional standards. Standard pertaining to skills and thoroughness, together with standard 1200, which emphasise the importance of competence in carrying out the internal auditor duty.

Similarly, in accordance to the issuance of standard by professional bodies (AICPA, 1975, 1991; IIA Standards; IFAC, 2009) have emphasized on competence of internal auditors, that is supported by several other studies (Brown, 1983; Schneider, 1984, 1985, 2003; Messier and Schneider, 1988; Maletta, 1993) which have measured competence as an important factor for IAF.

Internal audit requires staff that is professional and equipped with training, professional qualifications, experience and education to execute duties and responsibilities of audit as mandated (Al-Twajry et al., 2004). According to Lai and Liu (2018) stated competent internal auditors (i.e. good education level) will have a better ability to obtain and analyze pertinent information. Erasmus and Coetzee 2018, summarized that auditors' level of competence and professional attitude is essential factor for an effective IA's performance. Hence, this study expects competency to influence the effectiveness of internal auditing. Thus, the following hypothesis is proposed: -

H4: Internal auditor's competency is positively related to internal audit effectiveness.

Management Support

According to Ebissa (2015), top management support can be defined in the perspective of resources such as transport, training, finance, new technology that are supported by the management in performing the right way the duty of internal audit. Although there are numerous research shows there is an association between internal auditor's characteristics and internal audit effectiveness, management support nevertheless becomes essential.

Prior literature has stressed that the success of IA effectiveness is entirely dependent upon appreciation and support of senior management on the activities of IA. Similarly, Sterck and Bouckaert, 2006; Soh and Martinov-Bennie (2011) claimed that the relationship between senior management and internal audit is crucial from the perspective of reporting lines and support which contributes to the effectiveness of internal audit. This research complements other existing research such as Sarens and Beelde (2006); Sterck and Bouckaert (2006); Schneider (2008); Arena and Azzone (2009); Soh and Martinov-Bennie (2011); Lenz and Hahn (2015) which emphasized on the important role of management support on the activities of IA.

Whereas, study conducted by Alqudah, et al (2019) revealed that the lack of management support is critical factor which hampered the work of IA. Whereby, without the support from the senior management, IA will unable to carry out its duty independently (Alzeban and Gwilliam, 2014).

Radu (2012) stressed that the accomplishment of governance responsibilities of senior management could be achieved through the effectiveness of IA. Improvement in the performance of the company is achieved in return of good governance that harmonizes the interest of the stakeholders. Al-Thuneibat et al (2016) claims an establishment of comprehensive monitoring function which associated with internal control, will have better visibility and ability of monitoring activities at various management stages. Hence, this study expects management support to influence the effectiveness of internal auditing. Thus, the following hypothesis is proposed:-

H5: The relationship between internal auditor's characteristics and internal audit effectiveness is moderated by management support.

Theory

The theories that govern the theoretical framework of this study are the agency theory, and contingency theory. These two theories are discussed below.

Agency Theory

Glautier (1997) believes that agency theory models can explain human behaviour in organizations involving relationships between principals and agents. Principals are risk insurer, capital providers and incentives, while agents make decisions on behalf of principals and bear the risk of such decisions. The agency theory perceived that principals (owners) may not trust their agents (manager) due to mismatch in the information shared and unprincipled behaviours (Adams, 1994). Consequently, combination of audits performed by internal and external auditors are used as a tool to evaluate and control agent's behaviour to establish trust between principal-agent interests (Rusted et al., 2013).

In accordance to IIA Standard 1120, as part of the requirement internal auditors must be independent and objective. Whereby, internal auditors are a trusted individual in an organisation, will avoid any situation which will lead to an exploitation of their interest either personal or professional that is against their responsibilities. Personal interest of an internal auditor may will impede the auditors from executing their job responsibility neutrally.

Contingency Theory

According to Chenhall (2003), the word "contingency means something is only true under specified conditions. Hence, it denotes to a condition where the effects of one variable on other variables are depending upon third variables (Donaldson, 2001). Contingency theory has seen as one of the most influential theory which attracts attention of researcher's in large group especially in area of auditing and accountancy (Abushaiba & Zainuddin, 2012; Badara, 2015; Badara & Saidin, 2014; Ninlaphay & Ngamtampong, 2013).

Sudsomboon and Ussahawanitchakit (2009), used contingency theory in the area pertaining to success of audit, that concludes the factors such as quality of audit, audit reputation, stakeholder influence and professional competitiveness and professional regulation contingent upon audit success. According to Endaya and Hanefah (2013) claim that the relationship between the performance of internal audit department and internal auditor characteristics is contingent upon support from organisation member.

A Proposed Conceptual Model/Framework

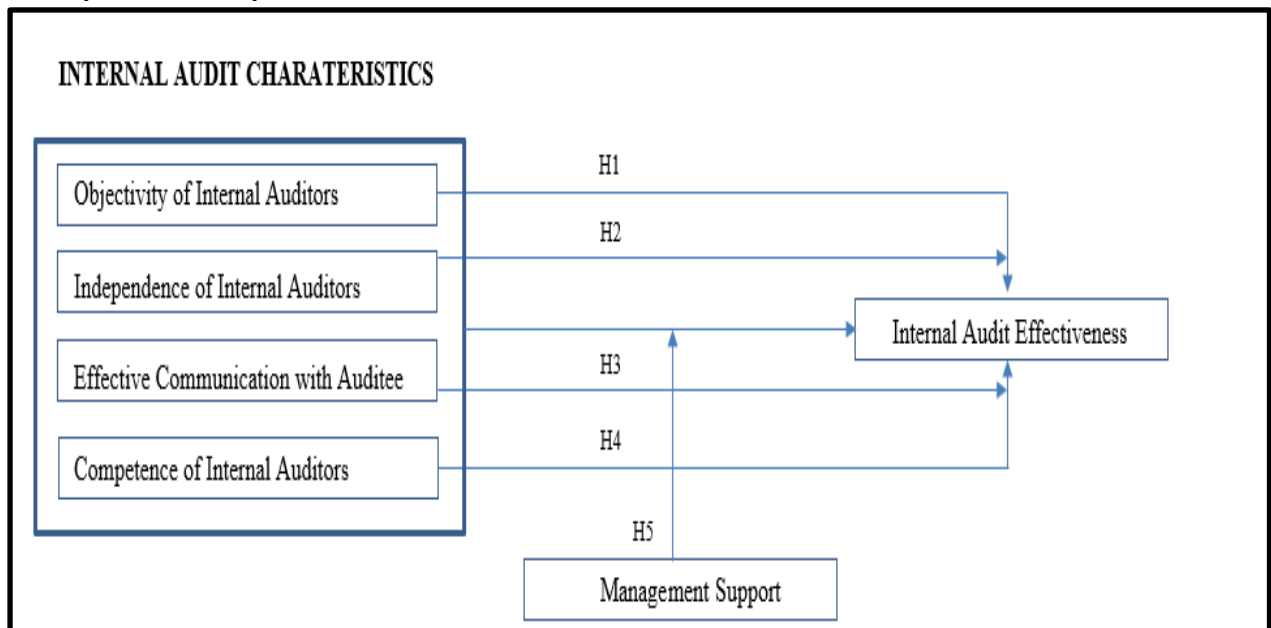


Figure 1. The Proposed Conceptual Model/Framework

Research Methodology

This conceptual paper is to examine the proposition that IAE is positively associated with IAC through MS as a moderator. The methodology adopted in this paper consists of library search and evaluate previous literature review on the area of IAE. The library search includes materials such as articles, journal articles and chapters in a book. Online database for instance Emerald Insight, ScienceDirect, Scopus, Web of Science and Google Scholar are used as reference. The advance searched consist of IAE, objectivity, competencies, independence, effective communication and management support. Therefore, limitation observed in this paper could be due to limited resources from database as search results have excluded studies related to Engineering and Medicine related to IA Effectiveness in a broader perspective. Moreover, the search criteria not just limited to Malaysia but also included worldwide IAE latest study from 2018 until now, 2023.

Conclusions

This conceptual paper provides evidence that the characteristics of internal auditor's consist of objectivity, independence, effective communication and competence are significantly related to IAE. Moreover, management support as moderator is an essential factor in this relationship. Agency theory used in this study is primarily to comprehend the fundamental motives of ongoing challenges encountered by internal auditors to accomplish their personal interests, although they are foreseen to go against the organisation interests. Whereas, contingency theory explains more on the dependencies upon internal and external factors that determine the success of an organisation. This study expects to enhance decision of policy makers in developing countries such as Malaysia in particular, in establishing appropriate guidelines and plans by adopting suitable measures which will lead to IA effectiveness. Therefore, concepts and results of IA effectiveness, that is established in this study, will be used by policy makers to further innovate IAF presentation and performance of the organisation overall.

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