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## PERSUADING DRIVERS OF INTERNAL AUDIT FUNCTIONS EFFECTIVENESS: DEVELOPMENT OF CONCEPTUAL MODEL



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### ABSTRACT

*This study aims to systematically review the previous literature on the drivers influencing internal audit effectiveness and coherent these drivers in a conceptual model. A 'systematic literature review (SLR)' is performed to detect the drivers that influence internal auditing more effectively. Relevant past literature is swotted between January 2005 to July 2022 as considered the important drivers affecting internal audit functions' effectiveness. Apart from these, all the guidelines mentioned in the international standards regarding internal audit given by the Institute of internal audit (IIA) have also been considered in this study. Three important outcomes are identified for the internal audit function to be effective: meeting the expectation of management, meeting the expectation of the audit committee, and meeting the expectation of auditees. Moreover, based on the SLR, ten important drivers are identified that mostly affect the internal audit effectiveness, such as culture, management support, audit committee support, organizational size, professional qualification, independence, working environment, internal audit budget, employee rotation policy, and proficiency of internal auditors. Based on the identified drivers and outcomes of internal audit effectiveness, this study proposed a conceptual model for internal audit effectiveness. The proposed conceptual model encourages the regulator, policy maker, and different stakeholders to make appropriate strategic decisions to make their internal audit department more effective.*

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### INTRODUCTION

Internal audit functions (IAF) act as a governance tool and can help ensure quality governance by providing external auditors, audit committees and management support. This idea is used as a premise in the first wave of research (Goodwin-Stewart & Kent, 2006; Prawitt et al., 2009). Previous studies show that internal audit's usefulness as a supervisory support lies primarily in its ability to (i) increase the consistency of financial information (Davidson et al., 2005; Prawitt et al., 2009) and (ii) to prevent, detect, and disclose both significant internal control weaknesses and financial fraud performed within the organization (Norman et al., 2010; von Bayern et al., 2009). Therefore, internal audit is considered to be an oversight mechanism and process that reduces agency problem for the benefit of related parties and especially shareholders by providing assurance and consulting services. Norman et al. (2010) argue that IAF raises concerns about fraud prevention, detection and disclosure, as internal auditors tend to protect the audit committee and management from adverse effects in some situations. That is why the internal audit function is very important to be effective.

Having "an effective IA function is important for organizations; the effective role, as interpreted by The International Professional Practices Framework for Internal Auditing (IPPF), will ultimately have a major contribution to improving the effectiveness of an organization's risk management, internal control, and governance processes" (Abdelrahim & Al-Malkawi, 2022, p. 2). IIA (2017) define the internal audit as "Internal auditing is defined by The Institute of Internal Auditors (IIA) as "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." In addition, effective internal audit is important to an organization's audit committee, senior management and external auditor. The internal

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auditors provide the audit committee and senior management with an objective assessment of the operations, processes and performance of the entire organization.

However, Barua et al. (2010) and Sarens and Abdolmohammadi (2011) argue that there is additional effect between the audit committee and the IAF. Some studies that investigated the 2007 financial crisis Chambers (2015) or associated the role of internal audit with the actual tasks of internal auditors. Christopher et al. (2009) argued that internal audit may not have properly performed its role in overseeing governance, but that internal audit is a control mechanism over governance and that IAQ is important to the benefit of shareholders. Chambers and Odar (2015) internal audit is not "fit for the purpose" and can be improved. Goodwin-Stewart (2006) also concluded that only poor support is available for an organization related to the use of internal auditing and firm corporate governance. Additionally, Brender et al. (2015) argued that although the IAF should be measured a tool to oversee the governance mechanisms and processes but it is not actually used as such. Although many organizations have an internal audit function, the organization's size, operations, and culture affect the internal audit function and vary from organization to organization. That is why it is very important to know which factors affect internal audit effectiveness. The factors influencing the effectiveness of IA are controversial in the literature, and several reviews have emphasized that many factors influence the effectiveness of IA. However, there is still no consensus among researchers on the optimal framework for internal audit to be effective. This could be related to the lack of a comprehensive conceptual model that includes the key factors for the effectiveness of the internal audit. As the use of internal audit is increasing day by day and its necessity and importance to the management, it is necessary to see what factors affect the work of the internal auditor. Furthermore, no particular attention has been paid to which conceptual model is the best for organization and its impact on the effectiveness.

Alzeban and Gwilliam (2014) point out that studies are needed to examine the drivers that impacts the effectiveness and to better understand the effectiveness of internal audit. Although the past studies have its own value, our effort is to intellectualize the drivers that affect audit effectiveness in a model, undoubtedly categorize the extents of these issues, and association them to effectiveness of internal audit functions. I have confidence in these issues by giving a complete model of the inducing drivers that distressing the effectiveness of internal audit functions. This study attempts to formulate a conceptual model based on the past literature. The main inspiration of this study is also to response the following question: is it possible to design a model that consider the drivers which inducing IAE? This paper answers this question by building on the IAE literature and its reasoning on the drivers affecting the effectiveness of internal audit functions.

The structure of this study is systematized as follows. The next section provides a literature review followed by a description of the research methodology. Then the conceptual model based on previous studies is presented showing that different drivers influence the IAE. The last part of this paper provides a conclusion and as well as recommendations for further studies.

## LITERATURE REVIEW

### Internal Audit Effectiveness

The effectiveness of the IA is contextually implied, as the IAF can be used for a variety of purposes in its particular organizational context. There are four main outcomes of IAE in the literature: 1) IA is effective when the requirements of the AC are met. 2) IA is effective when upper management requirements are met. 3) IA is effective when the expectations of external auditors are met. 4) Meeting the expectations of the audited entities.

### IA is effective when meeting the demands of the AC

The relationship between an organization's internal auditor and the AC has been the subject of scholarly research for many years, e.g. Rezaee (1993) believe that consistent collaboration and open discourse help the IAF to be most effective. Collaboration between the internal auditor and a company's audit committee occurs throughout the year, with an open relationship being most effective. IA is effective in meeting the requirements of the AC. Roussy (2016) has found that the Audit Committee's perception of the IAE sees the internal auditors as private consultants and high quality internal audits can only be obtained when the internal auditors work closely with and always on behalf of the top manager Audit committee and the frequent meetings of the audit committee there are with the internal audit department will increase the costs of the internal audit department (Barua et al., 2010).

The Belgian research by Sarens et al. (2009) considered the IAF to be the specialized information provider that provides comfort to the AC with the company's ongoing event, thereby reducing the problem of information discrimination. Informal consolation through personal contact and face-to-face meetings, as well as formal consolation such as the internal audit report to the Audit Committee, appear to be an important way of providing comfort to the AC. As a result, Soh Dominic (2011, p. 614) give the connection between the IAF and the AC as important for the effectiveness of the IA and place special emphasis on the importance of CAEs skills and competencies: A good CAE is functional with other stakeholders in the organization and is not afraid to speak his mind, even in controversial situations. Even a good CAE has no hesitation in reporting fraudulent information of any kind to the audit committee.

Davies (2009) study examines the working relationship between the IAF and the Board and attempts to view the relationship from the perspective of the AC Chair. Davies (2009) shows that it can take a long time for the IAF to attain a respectable status in an organization as the relationships between AC and IA largely depend on the administrative structure and the individual personality and willingness to cooperate. The study shows that there is an inconsistency on both sides of the table concerned about IAF and AC. The Davies (2009) study points out an interesting thought, namely that there is a fundamental difference between having a board and/or management wanting to see the right things for the IAF and supporting it, and the board and/or management remains silent or prevents the IAF from taking effect and possibly revealing things that members do not wish to disclose and acknowledge. Such an internal audit function can then be viewed more as

a Cinderella function (Davies, 2009). Therefore, it is important that any CAE (or IA employee) who encounters difficulties can report them with confidence and reliability without fear of having their services or employment terminated or terminated.

### **IA is Effective if Meeting the Needs of Top Management**

Chambers (2008) suggested that while other governance actors are also important to IA, the ultimate client is the board. Roussy (2013) noted that internal auditors believe their primary role is to serve top managers and the organization and those who are required to give priority to top manager at the expense of audit committee members. On the other hand, Beasley et al. (2009, p. 114) “the often unclear, informal nature of internal audit oversight by the audit committee and management (i.e. internal audit is overseen by two parties)”. The board takes precedence over other stakeholders with oversight responsibilities because of the importance of getting the boss right. Lenz and Sarens (2012, p. 540) recommended “focusing on one prime customer group foremost and aiming at satisfying the chief stakeholder first and in full is an alternative approach to targeting multiple customers at the same time and not satisfying anyone”. A study by Hoos et al. (2015) suggests that internal auditors have priority in management or AC depending on CAE instructions. That was resulted from an experiment in which the CAE allocates the IA staff to either management agenda (cost reduction) priority or the AC agenda (effectiveness). Rainer (2013) also includes senior management in his empirical design, which shows that the customer's satisfaction concept (matching expectations) can easily be confusing, because some managers are very few demands in the IAF. Lenz and Sarens (2012) shows that there can be “moments of truth” when senior management and the CAE cooperate and determine whether the CAE finally do well or flops in the detection of rendering an effective IA service. Lenz (2013, p. 276) concludes that, “CAEs who interact frequently and in a timely manner with senior management, using problem-solving communication, help and nurture IA effectiveness, especially when communication is supported by shared goals, shared knowledge, and mutual respect”.

### **IA is Effective if Meeting the Expectations of External Auditors**

The empirical literature assesses how other stakeholders (external auditors) assess the effectiveness of the internal audit. Lin et al. (2011) concluded that coordinating external and internal auditors increases the effectiveness of compliance processes. Flesher (1996) recommended that internal auditors and clients of audit services should have a common understanding of what makes IA a value-added activity, although he noted that internal auditors and auditors held similar views and felt that for functioning effectively: Internal auditors do not allow their role as business advisors to interfere with their ability to provide an independent opinion. Internal auditors should have business knowledge in various areas outside of accounting and finance. Albrecht et al. (1988, p. 3) conclude that what matters most is “that the audit work is completely consistent with the objectives and role as determined by top management and the audit committee”. While there is debate in the literature about the crucial customer of internal audit – whether IA is the “eyes and ears of the board or audit committee” and/or “the eyes and ears of management” (Anderson, 2003). Chambers (2008) stated that the internal auditor normally communicates with other internal governance stakeholders, i.e. management, the board and the AC and external auditors. Significant studies have been conducted to evaluate IA effectiveness from the viewpoint of external auditors noting that there is uncertainty in the external auditors (EA) whether IA is considered prominent players in the governance arena or “an assistant of the audit committee as a carrying out the direction as well as board instructions (Cohen & Sayag, 2010, p. 780). This points to concerns about independence of IA with internal auditors typically paid by the organization to which they can provide independent assurance and consulting services. Jiang et al. (2017) found that, there is a significant positive association with IAF (consulting service) and operating performance.

The question of the effectiveness of the internal audit is important for external auditors. They may need to discuss the quality of IA functions with the AC and the extent to which they can rely on the work done by the IA (Cohen & Sayag, 2010). When evaluating the effectiveness of IA from an EA perspective, the following applies: the higher the effective benefit of the EA, the higher the perceived IA quality. The value that EA sees in IA is dominated by the trust issue. The more work on IA that can be related to EA matters, the more appreciative EA can become. Because EA is based on financial reports, its focus may be far removed from the area where internal audit can make a difference. Modern internal audits will be risk based, with financial reporting issues not necessarily taking precedence. Therefore, reliance on EA as an indicator of internal audit effectiveness can be misleading.

### **Meeting Expectations of Auditees**

IA is effective in meeting the expectations of the auditee (an individual or organization being audited). While Arena and Azzzone (2009) point out that the efficiency and professional skills of internal auditors, adequate promotion of internal audit at company level and the processes of interaction between auditors and auditees and also the quality perceived by the auditees and management during the audit period, the most important factor for the effectiveness of the internal audit is whether or not the recommendations made by the IAF are implemented by auditee. Getie Mihret (2007) concluded that the characteristics of the audited entity (competence of the audited entity, attitude of the audited entity towards the internal audit, and degree of cooperation with the auditor) do not have a major impact on the performance of the internal audit.

## **MATERIALS AND METHODS**

Based on the research question and the associated goal, a systematic literature search (SLR) was carried out in this study. This study tracked the recommendation of Xiao and Watson (2019) who recognized eight stages to follow the SLR: (1) formulation of the research problem; (2) development and validation of the verification protocol; (3) literature search; (4) screening for inclusion; (5) quality assessment; (6) extracting data; (7) analysis and synthesis of data; and (8) reporting the results. The first step is ensured in the introduction part of this study where the research problem is articulated. The second

step is to progress and confirm the evaluation procedure which comprises the objective of the study. The literature review is the third step; the search was based on reliable online databases to identify relevant literature, including Scopus, Web of Science, Emerald Insight, Science Direct and SpringerLink. In the fourth step, literature was selected based on different disciplines that corresponded to the IPPF definition of the IIA's internal audit. Disciplines such as IA Effectiveness, IA Performance, IA Efficiency, IA Quality, and IA Value were the scholarly literature to which these terms referred for the extent to which the defined IA goals were met. After screening for the admission step, step five is to assess the quality of the selected works through a full-text review; in this step, the selected works are validated as to whether they meet the criteria developed. In step six, the selected papers are classified by author, year, research methodology, and factors used to examine the effectiveness of the impact assessment. The work is summarized and each factor affecting the effectiveness of the impact assessment is synthesized. The works selected for further analysis in step six are analyzed and synthesized in step seven, and in this step inclusion and exclusion criteria are again considered. In step eight, the synthesized reported factors influencing IA efficacy show the importance of each factor as explained in the fourth section of this document based on the relevant literature. Figure 1 shows the summary of SLR process.

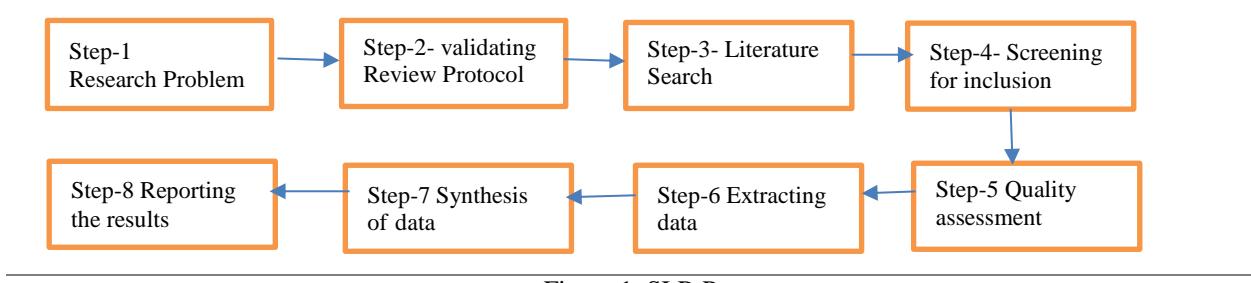


Figure 1. SLR Process

## RESULTS AND DISCUSSIONS

Organizational characteristics such as politics and culture, role of ambiguity and role conflict, company size, and internal control are also elements of internal auditor effectiveness. Sarens (2012) found that firm size was positively related to the active role of the IAF in corporate governance. By investing in the fixed costs of internal audit, large companies have the opportunity to benefit from economies of scale (Anderson et al., 1993). (Carcello et al., 2005) examined the elements associated with US public corporations' investments in internal audit (in terms of the IAF budget) and found that the IAF budget is absolutely related to firm size, using (Goodwin-Stewart, 2006) found a strong positive association between IAF size and firm size, suggesting that small firms do not view internal audit as cost-effective, (Anderson et al., 2012) also came to the same conclusion. Ismael Hazem (2018) concluded that firm size determines firm IAF. In some cases the studies contained inconsistent results, Carey et al. (2000) found no correlation between internal audit demand and company size. Goodwin-Stewart (2006) found that there is no significant relationship between internal auditing and the complexity of the organization's business structure. Getie Mihret (2007) emphasized that organizational frameworks (organizational framework, organizational profile, internal organization, organizational policies and procedures, internal audit budget status) do not have a major impact on audit performance.

Cohen and Sayag (2010) conclude that the effectiveness of IA depends more on organizational characteristics than IA skills and work environments. For example, the employee's rotation policy in the internal department also affects the quality of the internal audit. Christ et al. (2015) examined rotating internal audit programs and financial reporting quality and found that systematic rotation is associated with lower financial reporting quality, suggesting that using this practice may be more vulnerable to misleading or fraudulent financial reporting than companies, who do not practice using this. Ensure to the internal audit to have a great role in the financial reporting process. Using this practice, negative relationships between systemic rotation and financial reporting degradation can be reduced when compensatory control is employed, such as: (1) rotating only staff at internal audit sites (not CAE), (2) more effective audit committees, or (3) management ensures that internal audit plays an important role in the financial reporting process.

Arena and Azzone (2009) found that internal audit performance increases when the chief audit executive is affiliated with the Internal Auditor Institute. Criteria have been implemented to assess effectiveness, e.g. B. whether the key projects have been executed, whether they have been received from the IAF business units, whether the business units are willing to work with internal auditors and whether customer surveys have been carried out. In particular, feedback is provided from audit clients and a better understanding of how services are delivered. The CAE reports directly to the AC in the case study and to the CFO for administrative purposes. It helps to understand the order of the agreements made when setting up an IAF, what to do first and what is good to do, and provides a clue to the key levels of an effective IAF. Internal auditor skills are important and when setting up an IAF it is recommended to start with the CAE as the leader. According to Albrecht et al. (1988) assume that the effectiveness of impact assessment is the result of competent leadership by the incumbent CAE.

The role of CAE and the internal skills and expertise of internal auditors, organizational specifications, their policies and culture, management support and direct support from the audit committee as an important factor in determining internal audit effectiveness. Based on internal auditors' self-assessments, empirical research measured frequency and length of interaction (time), accounting skills and independence of AC members, and distinction between executive and non-executive directors on the audit committee. The profile/background of the members of the Board of Directors and Audit

Committee, their independence and their enthusiasm for working together and participating in internal audit are considered to be significant factors affecting the effectiveness of the IAF. Based on the above discussion, Figure 2 provides the conceptual framework of IAE.

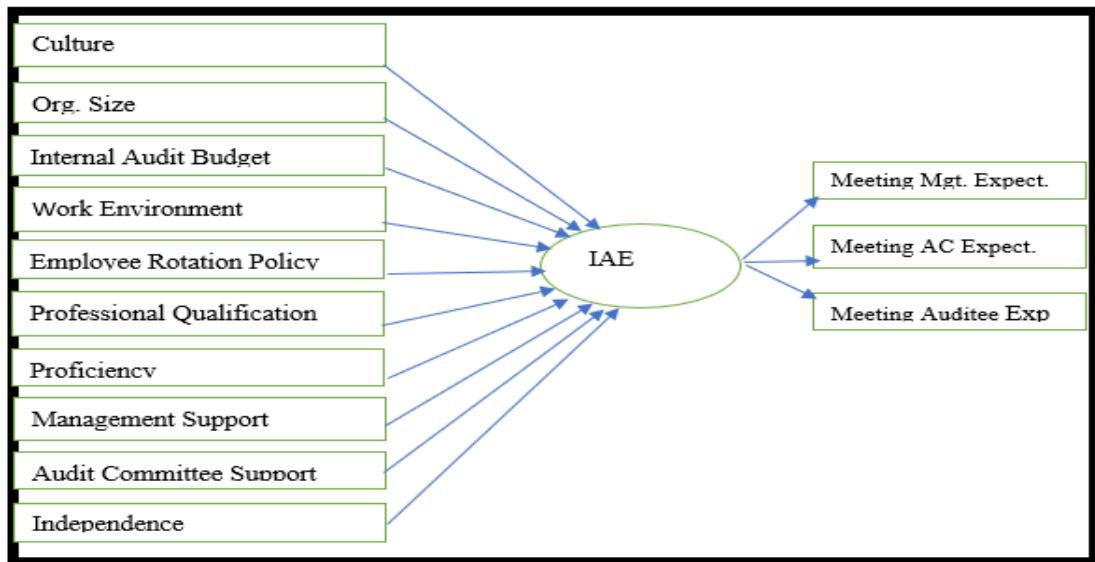


Figure 2. Conceptual Model

## CONCLUSIONS

This study conceded the important drivers of IAE based on a wide analysis of literature review and contended that the users are required a model that gives a complete interpretation and demonstrations the association between the important drivers and IAE. By following “systematic literature review (SLR)”, cover the time period from January 2005 to July 2022, this study increases the common body of knowledge of internal audit function by trying to consider the most important influential drivers of IAE and that shown in one conceptual model. The past studies basically focused on to find out the important factors of internal audit effectiveness, without giving the attention to provide a wide conceptual framework that is more accurate and appropriate in order to explain the theoretical justification of internal audit matters. In the past there is no consensus among the passed researcher about the important conceptual model for IAE. In addition, past researches have considered factors that are important to fulfill their objective by recharge but have not been able to provide a complete conceptual framework that users need to know. A number of past researchers have emphasized that an efficient conceptual model is needed to fully understand the internal audit, the extent to which internal auditors will perform, and improve the quality of their work. This study first conferred the concept of IAE based on the existing literature in order to understand what IAE means. Subsequently, the drivers influencing IA effectiveness and their dimensions were discussed and then proposed a conceptual model, based on what has been said in the literature, on which the model builds and which it extends of (Lenz & Hahn, 2015; Roussy et al., 2020). The contribution of the study is connected to the matter that the proposed conceptual model includes a complete understanding of the inducing drivers and their extents are obviously recognized in this model, and hence that model obviously deliberates the role of internal auditors in controlling the implementation of combined outcome of IAE as these functions is a new looking area and that should be considered If internal audit is to be effective. This conceptual model will drive further research to justify this model and build on it as well.

Furthermore, the proposed model in this paper needs empirical validation to extract the most important determination of IA effectiveness and the most significant factors. Moreover, the proposed model provides an opportunity to study the relationships between the influential factors, this could be possible through empirical study or to understand these relationships through case studies taking into consideration the agency theory and the institutional theory. In addition, based on the proposed model, comparative studies between IA functions existing in different industries or countries will provide insights into the key factors associated with IA effectiveness.

In addition, the model proposed in this study that requires empirical validation to identify the most important determination of IAE and the important outcomes of internal audit functions. Furthermore, the proposed conceptual model offers the possibility to examine the relationships between the important drivers, this might be possible by considering an empirical studies or interview to the auditors, management and audit committee to validate this model. Moreover, comparative study can be considered in compare this model in between developed and developing country to find out the any gap in between two economic area. Besides this issue, IAE has been usually observed by the past researchers as a unidimensional construct across dissimilar circumstances by using quantitative methodology, in future qualitative study can be conducted to assess and evaluate the important constructs and outcomes of IAE (Alqudah et al., 2019; Alzeban, 2020; Bednarek, 2018; Endaya Khaled, 2016; Salehi, 2016). In practice, this conceptual model gives internal auditors, board of directors and top management with a comprehensive understanding and complete interpretation of the important aspects that needs to be carefully considered if users are want to take any strategic decisions to improve their functions more effective. This study offers to policymakers and regulators insights to address the important drivers in the effectiveness of

internal audit functions whereas enlightening their corporate governance regulation.

Finally, this paper is not free from limitations. A possible limitation is that the literature reviewed in this study are exclusively related to internal audit and affect the performance of internal auditors are considered in this study. Moreover, no literature after July 2022 was considered in this study. Therefore, future research could consider gray literature to extend this study and gain further insight into the factor influencing IAE.

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