

Internal Audit Effectiveness in Libyan Public Enterprises: An Approach to the Development of a Theoretical Framework

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Abstract

This paper aims to investigate the relationship between effectiveness of the internal audit (IA) and the four factors related to International Standards for Professional Practice of Internal Auditing (ISPPIA) namely, independence; competence; scope of work; and work performance. It also aims to examine these factors (Internal auditors' pay satisfaction) and identify if it has any moderating effect on the relationship between these factors and the effectiveness of IA at Libyan public enterprises. This conceptual paper will employ the concept of institutional theory as well as the equity theory as an approach in the building up of a theoretical framework of the effectiveness of internal audit. This paper is a conceptual paper and it is an ongoing PhD thesis of the researcher.

Keywords: IA effectiveness, internal auditors' pay satisfaction, Libyan public enterprises

I. Introduction

As a result of an increase in accounting scandals and organizations being declared bankrupt in recent years, the IA function has received a great deal of attention as one of the important contributors to effective financial reporting and corporate governance (Prawitt *et al.*, 2008). In spite of the importance of IA effectiveness, there has been very limited research carried out which addresses the issue of IA effectiveness and the different approaches used in investigating IA effectiveness (Al-Twaijry *et al.*, 2003). Therefore, it is pertinent that the factors that influence the effectiveness of IA be identified as effective IA will lead to the improvement of the operations within the organization.

II. Background of The Study

According to Abu-Azza (2012), it is expected that IA will add value to organizations by providing a field of services that includes operational (performance) audits and consulting management on a diversity of issues. However, in spite of the importance of IA effectiveness, there has been very limited research carried out which addresses this issue, as different approaches were used in such investigations (Al-Twaijry *et al.*, 2003). Therefore, several academic scholars have called for further researches and have advocated the need for a more inclusive study of the issue of IA effectiveness (Al-Twaijry *et al.*, 2003; Prawitt *et al.*, 2008; Mihret and Yismaw, 2007). Historically, IA departments have faced many challenges; particularly concerning the satisfaction of employees as low

employee satisfaction will lead to a decrease in productivity (Shahnawaz and Jafri, 2009) Similarly, Hodge (2012) mentioned that, many internal auditors have become dissatisfied with the current jobs, which in turn has led to a reduction in productivity within the organization and has decreased the levels of performance. Heneman et al. (1997) states that pay satisfaction is one of the most important measures of organizational effectiveness. Therefore, it is important to examine the affect of internal auditors' pay satisfaction and other factors on IA effectiveness.

III. Problem Statement

The effectiveness of IA lies in the auditors' ability to achieve established goals and objectives within the organization (Dittenhofer, 2001) However, Hodge (2012) mentioned that, many internal auditors have become dissatisfied in the jobs, which has led to a reduction in productivity within the organization and has decreased the levels of performance. Such cases occur in developing countries such as Libya, where the value of the concepts and practices of IA may not be recognized by the organizations as in developed countries. In addition, most internal auditors who work in Libyan public enterprises were dissatisfied with the pay (Abu-Azza, 2012)

Despite the impotence of internal auditors satisfaction especially satisfaction with pay as an essential factors which may affect their performance as well as affect IA effectiveness, the impact of internal auditors' pay satisfaction on the IA effectiveness have not been examined by prior studies. Therefore, this paper attempts to fill the literature gap by examining the effectiveness of the IA function at Libyan public enterprise. It aims to examine the relationship between the four factors related to ISPPIA, as well as to determine whether this variable (Internal auditors' pay satisfaction) has any moderating effect on the relationship between these factors and IA effectiveness.

IV. Significance of the Research

In developing countries such as Libya, studying IA practice, in its broader context with identifying factors that inhibit or enhance its effectiveness, could pave the way for a deeper understanding of IA and for an increase in the development of knowledge in internal auditing areas as well as to maximize organizational performance; thereby rendering support for the development of the national economy, as developing countries have a greater need to similar studies to help increase and develop the general perspective about the importance of IA.

This study aims to evaluate the effectiveness of internal auditing within the Libyan public enterprises as it will be useful for practitioners and academics. For academics, it will further improve the understanding of the factors influencing IA effectiveness. For practitioners, it may help to solve the practical problems facing the internal audit effectiveness in the Libyan public sector enterprises. The results of the study may lead to recommendations to strengthen any weak areas revealed in the empirical survey.

V. Research Proposition

P1: There is a positive relationship between the factors that are related to ISPPIA namely, independence of internal auditors, competence of internal auditors, scope of internal auditing work and the performance of internal auditing work; and IA effectiveness at Libyan public enterprises.

P2: Internal auditors' pay satisfaction moderates the relationship between factors that are related to ISPPIA and IA effectiveness at Libyan public enterprises.

VI. Internal Audit Effectiveness

An effective IA function will add value and improve an organization's operations. The Institute of Internal Audit (IIA) [18] has defined IA effectiveness as "the degree (including quality) to which established objectives are achieved". In line with this, a program can be seen as effective if it can achieve the objectives and goals which it was established for and, IA should have the ability to achieve the goals and objectives that have been established from the management in order to improve the organization's performance (Dittenhofer, 2001). Many previous studies which have adopted the issue of IA effectiveness and have been used different ways to measure it (Abu-Azza, 2012; Mihret and Yismaw, 2007; Mihret *et al.*, 2010). None of these studies have examined the affect of internal auditors' pay satisfaction on IA effectiveness.

A. Independence of internal auditors

Auditor independence has long been considered as the key driver of the audit function. The ISPPA (glossary) defines independence as: "the freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels". IA independence is a substantial component of corporate governance and the control system, as without independence, the IA department becomes a part of the management group, losing its capacity to provide a fresh perspective (Al-Twajry *et al.*, 2003). Abu-Azza (2012), Cohen (2010), Haimon (1998) and (Mihret *et al.* (2010). found that internal auditor independence positively related to perceived IA effectiveness. Despite the importance of the independence of IA, limited research has focused on internal auditor independence. Therefore, this study is an extension of the previous one whereby the relationship between internal auditor independence and IA effectiveness has been examined.

B. Competence of internal auditors

With regards to professional competence, the ISPPA encourages internal auditors to obtain and update prior information about internal auditing, so as to be able to carry out assigned duties effectively. Competence is defined by Jessup (1991) as "the ability to perform to recognized standards". Alzeban and Sawan (2013) have mentioned that internal auditors should be adequately qualified and in possession of all requisite skills and knowledge to carry out responsibilities related to audit duties. Abu-Azza (2012), Haimon (1998), Mihret *et al.* (2010) and Obeid (2007) found that competence of internal auditors positively related to perceived IA effectiveness. In addition Many prior academic researchers have focused on the need for an internal auditor to be sufficiently qualified if a high level of effectiveness is to be achieved (Abu-Azza, 2012; Al-Twajry *et al.*, 2003; Mihret and Yismaw, 2007). Therefore, this study extends the prior studies by examining the relationship between competence of internal auditors and IA effectiveness.

C. Scope of internal auditing work

The scope of work is a substantial factor that affects the effectiveness of IA. The scope of IA has expanded from evaluating and measuring the internal controls effectiveness to the provision of consulting services related to organizational operations and systems developments (Dittenhoffer, 2001). In addition, the scope of IA encompasses consulting and assurance activities as it should cover the systematic review, reporting and appraisal of the sufficiency of the systems of financial, managerial, operational and budgetary control Institute of Internal Auditors , (2010) [17]. Cohen, 2010), Haimon (1998) and (Mihret *et al.* (2010) found that there is a positive relationship between scope of IA work and IA

effectiveness. It is then only pertinent that the relationship between the scope of IA work and IA effectiveness at Libyan public enterprises will be examined in this research.

D. Performance of internal auditing work

Work performance has been viewed as the most important factor that affects IA function (Abu-Azza, 2012). IA effectiveness is considered as the efficiency or performance of the activities within the IA function [24]. According to the definition of IA, it is expected that IA be value added and serve as a consulting function to the organization's management by; establishing audit plans, reviewing programs and operations to make sure that the results are consistent with the goals of the organization; effective management of IA operations, programs and reports to attain audit objectives and to determine adequate and appropriate timeframes to attain these objectives. Several earlier studies such as (Abu-Azza, 2012; Al-Twaijry *et al.*, 2003; Mihret and Yismaw, 2007) have mentioned that the internal auditor's work performance is an important factor that affects IA effectiveness. Abu-Azza (2012), Cohen (2010), Haimon (1998), and Mihret *et al.* (2010). have found that IA work performance is positively associated with IA effectiveness. Therefore, this study will be an extension of prior studies by examining such relationships between performance of internal auditing work and IA effectiveness.

VII. Internal Auditors' Pay Satisfaction As A Moderating Variable

Employees' pay satisfaction refers to the degree to which an employee is satisfied with the level and process of indirect or direct financial rewards received for the work done (Shahnawaz and Jafri, 2009). Haneman *et al.* (1997) states that pay satisfaction is one of the most important measures of organizational effectiveness. Organizations which have satisfied employees seem to be more effective than organizations with dissatisfied employees (Shahnawaz and Jafri, 2009). With regards to internal auditors, reference (Shahnawaz and Jafri (2009) have mentioned that, many internal auditors have become dissatisfied with jobs, which leads to a reduction in productivity within the organization and decreases the levels of performance. Similarly, Abu-Azza (2012) found that most internal auditors who work in Libyan public enterprises were dissatisfied with the pay. Therefore this study will examine if internal auditors' pay satisfaction has any moderating effect on the relationship between the factors that are related to ISPPA and IA effectiveness at Libyan public enterprises.

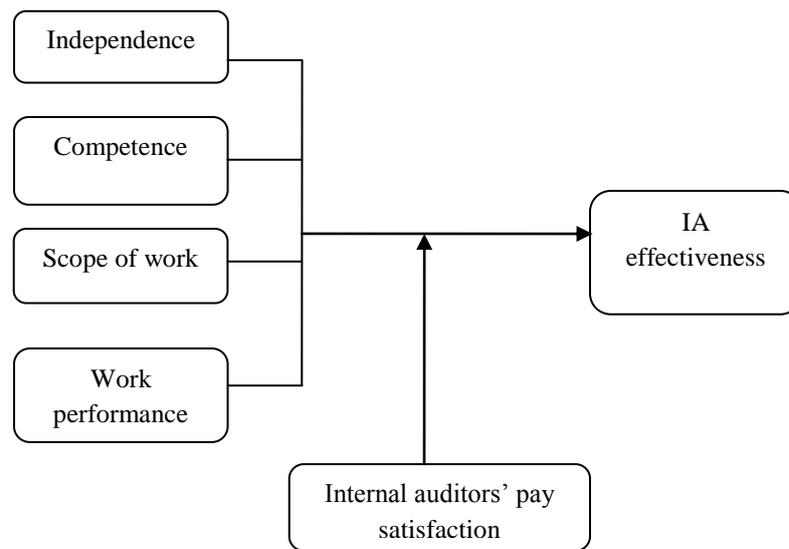


Figure 1: Conceptual Framework

VIII. Undertaking Theories

A. Institutional Theory

Institutional theory clarifies how organizational practices and structures are shaped through changes brought about by pressures, including both internal and external sources such as regulations and laws, or by the professions (Mihret *et al.*, 2010). The isomorphism process can take place in three ways: coercive, mimetic and normative isomorphism (DiMaggio and Powell, 1983).

With regards to the establishment IA departments, coercive isomorphism refers to pressures exerted in establishing IA departments within organizations. Mimetic isomorphism will come about when organizations realize that the function of IA will lead to improvements in the organization's performance, as this may engorge in the adoption of the IA department (Mihret *et al.*, 2010). Normative isomorphism occurs with increased proficiency within organizations, as this increase in professionalization is probable in achieving a greater commitment to IIA standers (Al-Twaijry *et al.*, 2003). With this perceived isomorphism, the activities of internal auditing would be established in line with IA profession to clarify the internal auditors' and IIA's knowledge and proficiency (Mihret *et al.*, 2010). The prominence and status of IA departments in the organization would thus be ensured which would lead other organizations to adopt ISPPIA (Al-Twaijry *et al.*, 2003).

B. Equity Theory

The basic doctrine of the equity theory is that, people are motivated to achieve a condition of equity when dealing with other people either within organizations or outside the origination Adams (1965). What the individual gives is called input (e.g. quality of performance, effort, experience) and what the individual receives, is called an outcome (e.g., pay, benefits) (Al-Twaijry *et al.*, 2003). If a person's outcome / input ratio are equal to that of another employee, equity exists and that will lead to higher pay satisfaction. On the contrary, if the outcome/ input ratio, is compared to other comparison' ratios, and is found to be unequal, then it would mean inequity exists and the employee is motivated to restore the equity by reducing inputs such as a decrease in efforts employed (Baron *et al.*, 2002). The Equity theory has been the most applied theory in pay satisfaction literature as it is very

important for organizations as pay satisfaction has a significant effect on job production and job satisfaction (Heneman, 1985).

IX. Proposed Methodology

This study will employ a quantitative approach to analysis data obtained from questionnaire surveys. The population for this study will be made up of internal auditors, the IA director and senior managers of the Libyan public enterprises (banking sector, insurance sector and manufacturing sector). Stratified purposive sampling will be adopted for the study. Correlation coefficients and multiple regression analysis will calculate and measure the impact of the independent variables on the dependent variables and allow the relationships among selected respondent groups to be investigated.

X. Conclusion

This research aims to examine the effect of the four factors related to ISPPA on IA effectiveness which has a moderating effect on internal auditors' pay satisfaction in the Libyan public enterprises. The contribution of this study extends the existing literature on the IA effectiveness by determining the effectiveness of IA at the public sector using the variables identified and discussed earlier. However, the proposed theoretical framework (fig. 1) of the recent study needs to conduct an empirical examination in future. Finally, this conceptual paper is an ongoing PhD thesis of the researcher.

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