

A Conceptual Perspective of Internal Audit Effectiveness to Prevent Fraud

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Abstract

This study aims to synthesize relevant theoretical and empirical literature to develop a conceptual framework and propositions about the antecedents of the effectiveness of internal audits for fraud prevention. This study uses a literature review approach and uses institutional theory, organizational support theory, and quality theory to develop a conceptual framework and produce propositions that are theoretically justified and supported by previous research. Conceptual frameworks and propositions are provided on the antecedents of internal audit effectiveness and their possible relationship to audit quality and management support. This study combines the three theories to provide additional insight to identify the antecedents and effectiveness of internal auditing and generate a conceptual framework that did not exist before.

Keywords

internal audit effectiveness; audit quality; management support



I. Introduction

The role of internal auditors is an essential part of the government system because the effectiveness of the internal audit function plays a role in detecting all fraud risks that may occur in the organization (Adetoso, J. Oladejo, K., & Akesinro, 2013; Labuschgne, H., and Moroney, 2006; Omar, N. & Bakar, 2012). In particular, fraud in preparing financial statements (Behn, Carcello, Hermanson, & Hermanson, 1999) and administrative corruption (Asiedu & Deffor, 2017). The existence of the internal audit function is relatively strategic. Halbouni (2015) reveals that internal auditors have a perception that they have more responsibilities related to reporting fraud in the organization than external auditors. Internal auditors have more experience (Salameh & Al-Weshah, 2011) in-depth knowledge of organizational culture, policies, and procedures, and knowledge of the possibility of fraud within the organization than external auditors (Kuntandi, 2015) so that they are faster in obtaining information and finding information. Problems at an earlier stage (Xiangdong, 1997). Coram, P., Ferguson, C., & Moroney (2008) asserted that organizations with a practical internal audit function tend to be better than those not, especially for fraud detection and prevention. Therefore, it is crucial to examine the effectiveness of internal audits (IA) in the context of detecting and preventing fraud.

This research uses Institutional Theory (DiMaggio & Powell, 1983). This theory focuses on three opposing mechanisms - coercive, normative, and mimetic. Coercive and normative pressures underlie the internal audit function to realize its effectiveness by increasing professionalism and complying with the norms of professional behavior regulated by standards. This theory is in line with one of the concepts of AI effectiveness proposed by

White (1976), namely, the effectiveness of internal audit is determined by the conformity between the audit and some universal standards extrapolated from the characteristics of AI. Therefore, the researcher chose the variables of competence & professional skills, independence of the internal audit function, objectivity, and quality of audit work because these variables are part of the basic principles, general standards, and standards for the implementation of internal audit, which are regulated in the Indonesian Government Internal Audit Standards/Standar Audit Intern Pemerintah Indonesia (SAIPI) and Government Internal Supervisory Apparatus Audit Standards/Standar Audit Aparatur Pengawas Intern Pemerintah (SA-APIP).

Furthermore, mimetic pressure becomes the basis for local government internal audit functions to use Information Technology (IT) in carrying out their work as has been used by external government auditors, internal auditors in private organizations, or internal auditors at the ministry level. IT is an adaptation of advances and technological demands from the industrial era 4.0 in Indonesia. Therefore, the researcher uses the Information Technology variable as one of the independent variables in this study

Institutional theory only emphasizes compliance to meet standards, has not considered aspects of organizational support. In this case, leadership support based on the organizational support theory model (Rhoades & Eisenberger, 2002) can affect organizational performance. Organizational performance in this study is the effectiveness of the internal audit function in preventing fraud. The results of previous studies (Cohen & Sayag, 2010; Getie Mihret & Wondim Yismaw, 2007) show that top management support is the most influential variable on the effectiveness of AI and the driving force of other determinants. In addition to directly influencing AI effectiveness (Alzeban & Gwilliam, 2014; Cohen & Sayag, 2010; Shohihah, Djamhuri, & Purwanti, 2018; Tackie, Marfo-Yiadom, & Oduro Achina, 2016) management support is also considered a moderator of IA effectiveness. Through objectivity, effective communication, proficiency & due professional care, and training and development (K. A. Endaya & Hanefah, 2016) and the use of information technology (Alkebsi & Aziz, 2017). However, previous research was conducted on private sector internal auditors. Therefore, it is necessary to carry out empirical testing using an analysis unit of local government internal auditors (public sector) which have different characteristics or focus with the private sector (Cohen & Sayag, 2010; Goodwin, 2003).

This study also modifies institutional theory by adding quality theory (Teas, 1994) which reveals that to achieve quality audit work, service providers must have three criteria, namely professionalism and skills; attitudes and behavior; and reputation. This study focuses on the first and second criteria: professional competence and skills, information technology, organizational independence, and objectivity that internal auditors must possess to achieve quality audit work. Previous research has proven a direct influence between competence & professional skills; the independence of the internal audit function; objectivity; and information technology, and the quality of audit work on the effectiveness of internal audits (Al-Twajry, Brierley, & Gwilliam, 2003; Cohen & Sayag, 2010; K. A. Endaya & Hanefah, 2016; Tackie et al., 2016) as well as the relationship between competence and professional skills; independence; objectivity and information technology on internal audit quality (Abbott, Daugherty, Parker, & Peters, 2016; Bierstaker, Burnaby, & Thibodeau, 2001; Ege, 2015; Pizzini, Lin, & Ziegenfuss, 2012; Prawitt, Sharp, & Wood, 2012).

Based on the combination of institutional theory, organizational support theory, quality theory, and gap research from previous studies, this study aims to build a conceptual framework and propositions about the effectiveness of IA with a series of antecedents in a more comprehensive relationship.

II. Review of Literature

2.1 Institutional Theory

The institutional theory assumes that corporate structure and behavior changes are driven less by a desire to increase efficiency or create competitive advantage but rather because of a need for legitimacy (Meyer & Rowan, 1977). The importance of legitimacy is also expressed by Weber (1978) that the leader/ruler can be forced out of office if he does not have legitimacy; that is, when he has less support from the people and when people see a more promising alternative way of satisfying their goals than obedience to authority. The same logic applies to institutions and organizations in general and IA in particular. Legitimacy is necessary for survival, and providing evidence of added value and effectiveness is one way to be perceived as legitimate in the eyes of key stakeholders (Lenz et al., 2018).

Institutional theory is closely related to the organizational environment. Carruthers (1995) revealed that the new institutionalism describes an organizational structure influenced by the social environment in which it is located. According to institutional theory, companies always aim to maintain and increase legitimacy through pressure from their institutional environment (Mizruchi & Fein, 1999). Therefore, organizations carry out a process of imitation and obedience, which DiMaggio and Powell call institutional isomorphism. Isomorphism is a 'constraining process' that forces one unit in the population to have the same shape and characteristics as other units that face the same environmental conditions.

Previous research has shown that the influence of government (compared to the impact of market forces) on the development of internal audits tends to be prominent in some countries (see, for example, Al-Twaijry et al., 2003). Therefore, the institutional theory allows the study of internal audits from multiple perspectives. Institutional theory has several implications related to the possible context-dependence of AI effectiveness. For example, in an organization exposed to high risk, one might expect mimetic pressure to contribute to the development of AI. The organization will imitate other organizations' practices in managing risk by establishing an internal audit department. It shows a positive relationship between the level of organizational risk exposure and the effectiveness of internal audits (Goodwin-Stewart & Kent, 2006). Likewise, internal audit focus as an assurance or consulting differs between government and private sector organizations (Carcello, Hermanson, & Raghunandan, 2005).

2.2 Organizational Support Theory

According to organizational support theory, the development of Perceived Organizational Support (POS) was driven by the tendency to assign organizations similar to human characteristics (Eisenberger, Huntington, Hutchison, & Sowa, 1986). Levinson (1965) noted that actions taken by agents from the organization are often viewed as an indication of organizational intentions rather than being linked solely to the agent's motives. Levinson's suggested personification of the organization is supported: First, by the organization's legal, moral, and financial responsibility for the actions of its agents; Second, by organizational policies, norms, and culture that provide continuity and determine role behavior; and third, the agency's power to mobilize employees. Based on organizational personification, employees view the organization's treatment (good or bad) as an indication that the organization likes or dislikes them.

2.3 Quality Theory

Quality theory in this study is used to explain how quality products or services are. According to Crosby (1980), quality shows conformance to requirements, following what is

standardized. For a product or service to be produced according to standards, it must be done by people who have high skills and good attitudes. It is further explained that a product or service is of quality if it follows what is standardized and carried out by people with high skills and good attitudes according to their fields. Quality emphasizes aspects of the final result, namely products or services, and concerns human resources, process quality, and environmental quality. Meanwhile, users' expectations of products or services constantly change, so the quality must also change. With these quality changes, it is necessary to change or increase resources, process changes, and environmental changes so that the product or service can meet or exceed the expectations of its users.

III. Discussion

3.1 Internal Audit Effectiveness

Internal audit is said to be effective if it meets the expected results. Ridley (2008) claims that modern IA has been built on the three "Es" of effectiveness, efficiency, and economy. Chambers (1992) views effectiveness as "doing the right thing," efficiency means "doing it well," and economics means "doing it cheaply." The above definition shows that effectiveness is a more important characteristic of IAF than efficiency. If IA is not adequate, in the end, it does not matter how efficiently or economically it is done.

Dittenhofer (2008) reveals that something is effective when it achieves its goals and ensures conditions as desired. Dittenhofer also explained that internal audit is effective when it can help the organization achieve its goals, although there are difficulties in determining the appropriate measurement criteria to confirm effectiveness. Thus, effectiveness, in particular the effectiveness of IA, is something that is not clear, so it must be defined. Furthermore (Lenz, Sarens, & Jeppesen (2018) define the effectiveness of internal audit as a risk-based concept that helps organizations achieve their goals by positively influencing the quality of corporate governance.

Cohen and Sayag (2010) examined the Israeli public and private sectors using two perceptions. The perception of the internal auditor is used to measure the independent variable and the manager's perception to measure the dependent variable, namely the effectiveness of IA. These two perceptions are used to avoid possible errors, which often occur when all data are collected from the same source.

3.2 The Role of Internal Auditors to Prevent Fraud

The relationship between fraud and the internal audit function in developed and developing countries has been discussed in previous literature (Brierley, El-Nafabi, & Gwilliam, 2001; D'Onza, Selim, Melville, & Allegrini, 2015; Halbouni, 2015). Most researchers argue that the internal audit function is an essential value-added process to uncover and prevent fraud in an institution (Abbott, Parker, & Peters, 2012; Burnaby, Howe, & Muehlmann, 2011; Richards, 2002). Halbouni (2015) and Thomas & Clements (2002) believe that internal auditors' primary purpose is not to oversee fraud prevention programs. Instead, internal auditors have a role in assisting in identifying fraud risks in institutions. The ACFE survey in 2008 and 2010, cited in Halbouni (2015), found that internal auditors initially detected fraudulent activity in more than 19 percent of fraud cases (ACFE, 2008). This 19 percent is a drastic increase compared to 9 percent of fraud cases disclosed by external auditors (ACFE, 2008). In 2010, only 4.6 percent of fraud incidents were detected by external auditors. Despite this relatively low percentage, ACFE (2008) concludes that the internal audit department is the most critical entity to detect and limit asset misappropriation and corruption schemes. ACFE argues that internal auditors are more critical than management personnel concerning reviewing internal controls, establishing fraud hotlines, providing rewards for whistleblowers, conducting

surprise audits, mandating job rotations and vacations. They are, moreover, auditing the internal controls of financial reporting (Burnaby et al., 2011).

3.3 Competence and Professional Proficiency

Proper staffing of the internal audit department and good management of such staff are the keys to effective internal audit operations. An audit requires professional staff who collectively have the education, training, experience, and professional qualifications necessary to carry out the various audits required by their mandate (Al-Twajjry et al., 2003). Previous research on professional competence and skills has been carried out in the private sector, including Deribe and Regasa (2014) on commercial banks in Ethiopia. A survey method shows that competence is the main factor besides performance and information technology positively affecting audit quality. In addition to affecting audit quality, the competence of internal auditors also has a positive effect on the effectiveness of the internal audit function (Alzeban & Gwilliam, 2014; Shohihah et al., 2018).

3.4 Independence of the Internal Audit Function

Auditor independence has long been seen as the main driver of the auditor's role. The independence and objectivity of the internal audit department have been identified as critical elements of its effectiveness (CIPFA, 2003). Through their empirical studies, Cohen and Sayag (2010) and Alzeban and Gwilliam (2014) found a positive relationship between organizational independence and the effectiveness of the internal audit function. In addition, Lee and Stone (1995) found an influence between audit independence and competence on audit quality. Without independence, audit opinion is meaningless because the audit's success largely depends on the auditor's independence.

3.5 Internal Auditor Objectivity

Objectivity is a crucial element of the effectiveness of internal audits (Schneider, 2003) because internal auditors must provide a professional assessment to the auditee, and without objectivity, the assessment will lose value and become meaningless. The principle of objectivity requires that the auditor performs assignments honestly and does not compromise on quality. The need for objectivity is evident in private and public sectors because users of audit services depend partly on their opinions when making decisions. Previous research revealed that objectivity is one of the variables that influence the quality of the internal audit function and the competence and work of the external auditor's perception (Messier & Schneider, 1988). Furthermore, Endaya and Hanefah (2016), through survey research on the association of accountants and auditors in Libya, prove that auditor characteristics, one of which is objectivity, has a positive effect on the effectiveness of internal audit

3.6 Information Technology

The most important reason for researching and developing information technology is its widespread use and how it has changed the organizational environment of both the private and public sectors. Information technology has shortened the processing time and performing many tasks, including the internal audit function. According to Pramusinto (2020) the power of technology including digitalization and automation continues to grow and change the pattern of production, distribution, and consumption. As with other areas of life, technology is used to make changes, so also with the legal system as technology in making changes (Hartanto, 2020). Meanwhile, the use of information technology is the benefit expected by users of information systems in carrying out their duties where the measurement is based on the intensity of utilization, the frequency of use and the number of applications or software used (Marlizar, 2021). The overarching objective of the internal audit function is to provide

independent assurance on the effectiveness and adequacy of the organization's governance, controls, and risk management processes (Christopher, 2015; Hay, Stewart, & Botica Redmayne, 2017; The Institute of Internal Auditor, 2016).

3.7 Organizational Support

The Review of Internal Auditing Standards (The Institute of Internal Auditor, 2016) clearly shows that an adequate level of organizational support is required for internal audit existence and day-to-day functioning. Management or leadership support is felt by the internal auditor function in several ways, namely First, the internal audit function is valued and considered necessary by management or in other words management does not underestimate the internal audit function (Al-Twaijry et al., 2003); Second, management or auditees follow all internal audit recommendations (Al-Twaijry et al., 2003; Alzeban & Gwilliam, 2014; A. K. Endaya & Hanefah, 2013; K. A. Endaya & Hanefah, 2016; Getie Mihret & Wondim Yismaw, 2007); Third, realizing the needs of internal auditors by providing the necessary resources including employees and budgets as needed (Alzeban & Gwilliam, 2014; Cohen & Sayag, 2010; Tackie et al., 2016); Fourth, support and encourage internal auditors to participate in IA staff training and development (Cohen & Sayag, 2010; Tackie et al., 2016); Fifth, internal audit has unrestricted access to review the work of senior management (K. A. Endaya & Hanefah, 2016); Sixth, the Chief audit executive has open communication with senior management (K. A. Endaya & Hanefah, 2016); Seventh, involvement in the internal audit plan; Eighth, reports on the work of the internal audit team submitted to management; and Ninth supports internal audit to carry out its duties and responsibilities (Alzeban & Gwilliam, 2014).

3.8 Audit Quality

The concept and terminology of audit quality have various interpretations and is abstract so that it cannot be defined singly, but the context must also be considered. DeAngelo (1981) states that audit quality is assessed from the ability of the auditor to find and report material misstatements in the client's financial statements. The auditor's ability depends on technical prowess, problem-solving ability, risk profile, willingness to work as a team, courage to report material errors, and an independent attitude from the influence of other parties.

3.9 Conceptual Framework and Propositions

The literature has primarily examined how these factors influence IA adoption. The next logical step is to look at the implications of these factors and their interactions in shaping the effectiveness of the internal audit. Therefore, consistent with the arguments of institutional theory, organizational support theory, and quality theory, the propositions of the conceptual framework (figure 1) are:

- P1: Professional Competence and Skills have a positive effect on audit quality
- P2: The independence of the internal audit function has a positive effect on audit quality
- P3: The objectivity of internal auditors has a positive effect on the quality of internal audit
- P4: Information technology has a positive effect on the quality of internal audits.
- P5: Competence and professional proficiency positively affect the effectiveness of internal audits for fraud prevention.
- P5a: Management support moderates the effect of competence and professional skills on the effectiveness of internal audits for fraud prevention.
- P6: The internal audit function's independence positively affects the effectiveness of internal audits for fraud prevention.

- Q6a: Management support moderates the effect of the internal audit function's independence on the effectiveness of internal audits for fraud prevention.
- P7: The objectivity of internal auditors has a positive effect on the effectiveness of internal audits for fraud prevention.
- Q7a: Management support moderates the effect of internal auditors' objectivity on the effectiveness of internal audits for fraud prevention.
- P8: Information technology has a positive effect on the effectiveness of the internal audit.
- Q8a: Management support moderates the effect of information technology on the effectiveness of internal audits for fraud prevention.
- P9: Audit quality has a positive effect on the effectiveness of the internal audit.

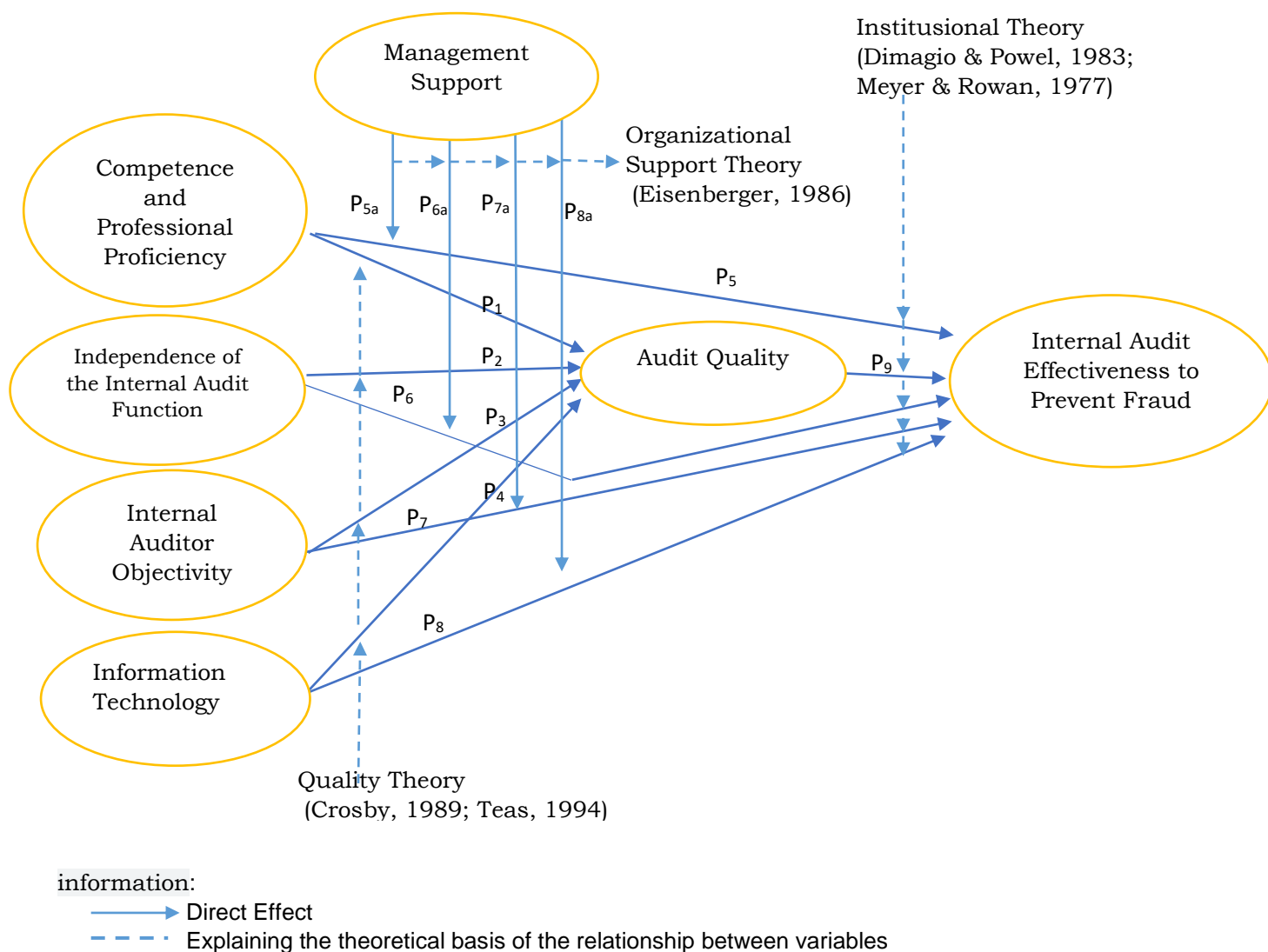


Figure 1. Conceptual Framework with Proposition

IV. Conclusion

This study argues that institutional theory, organizational support theory, and quality theory can help build a theoretical framework for the effectiveness of internal audits for fraud prevention. The existing literature shows a) the limitations of quantitative research on the effectiveness of internal audit that refers to specific theories (Nerantzidis, Pazarskis,

Drogalas, & Galanis, 2020) or without a theoretical framework (A. K. Endaya & Hanefah, 2013); b) although several previous studies have considering some contextual antecedent effects, the possible interaction of these antecedents on the effectiveness of internal audit has not been fully explored; c) limited studies on the public sector, especially local government, most of the previous studies focused on private sector companies in developed countries. Therefore, this study seeks to fill this gap by combining theories to develop propositions.

Researching the factors that affect the effectiveness of IA has been carried out by previous researchers, but the effectiveness of internal audit that focuses on fraud prevention is still rarely found. The antecedents in the context of fraud prevention are considered in this study: professional competence and expertise, the objectivity of internal auditors, independence, information technology, management support, and audit quality. Internal auditors must have professional competence and expertise in evaluating fraud risk and managing it. Furthermore, to achieve effectiveness in preventing fraud, internal auditor objectivity and an independent mental attitude are needed to report fraud and material errors in the accounting system and financial statements. Then, the use of information technology, namely the use of applications or software in the audit process starting from the planning, implementation, reporting stages to the audit follow-up stage, making it easier and faster for auditors to carry out their work, especially for the realization of real-time auditing. Another factor that affects the effectiveness of internal audits is audit quality, namely the ability of the internal audit function to provide valuable findings and recommendations. The last is management support which is a determining factor for implementing or not of the recommendations made by the internal auditor.

Previous research has tested the relationship of management support as a moderating variable (Alkebsi & Aziz, 2017; K. A. Endaya & Hanefah, 2016) but in the private sector internal auditor analysis unit. Therefore, it is necessary to test the public sector, especially the local government internal auditors, who have different characteristics from the private sector. Furthermore, previous research places audit quality as an independent variable. No previous research places it as a variable that mediates the relationship of competence & professional skills, independence of the internal audit function, the objectivity of internal auditors, and information technology to the effectiveness of the internal audit. This study suggests testing the indirect relationship based on a combination of institutional theory and quality theory.

This study emphasizes the need to empirically test the effectiveness of internal audits within the suggested theoretical framework to identify antecedents in the context of fraud prevention by further developing the propositions offered in this paper into testable research hypotheses. We are examining the factors that affect the effectiveness of IA and the possible interactions between them based on the existing theoretical framework is expected to provide a more comprehensive understanding of the effectiveness of internal audit and how to improve it.

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