

THE EFFECT OF INTERNAL AUDIT TOWARDS INTERNAL CONTROL SYSTEM EFFECTIVENESS.

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ABSTRACT

Internal audit is an independent, objective assurance and consulting activity designed to add value and improve and organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes (Institute of Internal Auditing). In most business organisations nowadays, the internal audit is not only functioned as internal control reviewer but also played an important role as business risk assessor. Meanwhile internal control system is a set of policies and procedures established by management to enable the organisation to achieve its objectives. It is a process designed to provide reasonable assurance regarding the achievement of business objectives (The Committee of Sponsoring Organisation of the Treadway Committee, 1992). Internal audit is expected to assess risk and then setting up strategies to manage the risk through development of systematics and structured control procedures. Hence, the intention of this paper is to explore the effect of internal auditing towards internal control system effectiveness in higher learning institutions in Selangor. Internal control systems were looked from the perspectives of control environment, risk assessment, control activities, information and communication and monitoring (Badara & Saidin, 2013). This paper is a conceptual paper and conducted by reviewing previous studies as research designs. This paper concludes that, internal audit may influence internal control system effectiveness of higher learning institutions and it needs to be proven empirically by field work study.

Keywords: *Internal audit, internal control effectiveness, governance.*

INTRODUCTION

Internal audit normally focus on good internal control and compliance towards policies and rules to ensure the organization is operated in effectively manner thus able to achieve its objectives. Theoretically, the internal audit function exists to help members of an organization to improve the performance of their activities (Ali et al, 2012). The main factor in the development of internal auditing was the wider span of control faced by management in operations spread over different locations (Ferdinand & Mahzan, 2013). Company's management may also depend on internal audit function in detecting fraud.

Moreover, the urge of applying good governance in organisation has promoting the importance of internal audit function. The roles of internal audit seem to be widened. Nowadays, internal auditor also plays an important role in assisting the audit committee in fulfilling their jobs. Internal auditor is expected to have good skill in assessing risk (Ahmad, et.al. 2009; Dittenhofer, 2001) and develop an action plan how to mitigate those risks.

Specifically, the role of internal auditor is assessing internal control systems, which consists of rules and standards set up by the management. Other than that, internal auditor also responsible to provide advices on how to improve the control systems and corrective action if needed. The advices and suggestions given are normally based on the ability of the auditor to foresee the future uncertainty events that may happen due to current weaknesses or loopholes of the control systems.

Meanwhile, a set of internal control system consist of policies and procedures basically developed by management to manage risk and provide reasonable assurance that the organization would achieve its objectives. The main objectives of internal control system are to ensure reliability of financial reporting, efficiency and effectiveness of operations and compliance with law and regulations. Internal control system consists of five important elements, which control environment, risk assessment, control activities, information and communication and monitoring (Arens et.al. 2008). Control environment describe the tone at the top of organisation's management. It is very important because the attitude of top management towards good control and risk management would influence the attitude the rest of the staffs. If top management believes that control is important, others in organization will sense that and respond by conscientiously observing the control established (Arens et.al. 2008). Meanwhile risk assessment is management's identification and analysis of risk. It also relates with the plan and action taken by management in mitigating and manages the risk.

Control procedures are policies and procedures develop in addressing the risk. Control procedure might be divided into several types such as adequate separation of duties, adequate documents and records, physical control over assets and records, proper authorization of transactions and independent checks on performance. The purpose of entity's information and communication is to initiate, record, process and report every single transactions. This to ensure the accountability of every single amount disclose in the financial statements. Monitoring activities deals with ongoing or periodic assessment of the performance of internal control systems by management. This activities is to ensure that the control is operated as intended and any irrelevant control may be modified and renew so that meet the current situation's problems.

Internal control systems are seen as one of important element in any organisation. The control system normally embedded into structure, policies and procedures of organization. An organization without proper control systems would normally suffer a lot of problems such as rise of cost and loss of cash. It is a responsibility of management to establish and maintaining reasonable internal control systems. Management not only liable to design and develop internal control system but also review the effectiveness of the control. The purpose of the review is to ascertain whether the organisation's objectives and goals have been achieved. (Fadzil, 2005).

Section 404a of the Sarbanes-Oxley Act highlight management's responsibility in this area. Section 404a requires management to both maintain and annually assess the quality of internal control in a publicly available report. To support this assessment, management has chosen to rely heavily upon the work of its internal audit function (Arel, 2006). Internal auditing practices appraise the effectiveness of internal control systems, which also includes an appraisal of the actions by management to correct situations, which are at variance with planned outcomes (Fadzil, 2005).

When announcing the release of the COSO framework, the Institute of Internal Auditors (IIA) issued a statement commenting on the internal auditor's role in risk management (IIA, 2004a). The following extract from that statement confirms that the IIA supports an active role for internal auditors in enterprise risk management (Zwaan & Stewart, 2011), including making recommendations to improve the organisation's risk processes:

“Internal auditors should assist both management and the audit committee in their risk management responsibilities and oversight roles by examining, evaluating, reporting and recommending improvements on the adequacy and effectiveness of management's risk processes”.

INTERNAL AUDIT FUNCTION

Theoretically, the internal audit function exists to help members of an organization to improve the performance of their activities (Ali et.al.2012). It also become more important because an effective internal audit function is considered part of the solution to the perceived breakdown in the systems of business reporting, internal control and ethical behavior (Arel, 2006).

Some of major roles and responsibilities of internal audit function are evaluates and provides reasonable assurance that risk management, control, and governance systems are functioning as intended and will enable the organisation's objectives and goals to be met. Reports risk management issues and internal controls deficiencies identified directly to the audit committee and provides recommendations for improving the organisation's operations, in terms of both efficient and effective performance, evaluates information security and associated risk exposures, evaluates regulatory compliance program with consultation from legal counsel, maintains open communication with management and the audit committee, engages in continuous education and staff development and provides support to the company's anti-fraud programs.

In 1999, IIA has issued a guidelines for internal auditor in performing internal audit work through Standards for the Professional Practice of Internal Auditing (SPPIA). This standards were classified into three categories which are, attribute standards, relate with the characteristics of individuals or internal auditing departments, performance standards describe internal audit activities and criteria for their quality, and implementation standards which discuss specific types of engagements, such as performance or compliance audits (Mcdonald 2003).

Ali et. al 2013 describe internal audit function in public sector holds high potential for promoting accountability and improving government performance. Policy measures on internal audit includes: requiring the establishment of internal audit units, establishment of standards for the professional conduct of internal audit work; training' resource allocation; expanding reporting arrangements and broadening mandates to make auditors responsible for performance assessments and understanding internal control as an import tools of accountability.

Institutions of higher education are facing demand for accountability (Chamberlain et al, 1993), where issues all over the world should shift the focus of internal auditors involvement in evaluating the risk exposure, control and governance of the organization. The findings revealed that a substantial number of public and private higher education institutions do not have an internal audit function. However, public academic institutions comply with the guidelines issued by the Treasury Circular. Internal auditing is part of the governance structure in organization as a mechanism to assist the management in providing better control of the institution's resources and quality education provided (Zakaria, Selvaraj & Zakaria, 2006).

INTERNAL CONTROL EFFECTIVENESS

Effectiveness has been define as the capacity to obtain results that are consistent with target objectives (Arena et.al. 2006). Other than that, a program can be seen as effective if its outcome goes along with its objectives (Ahmad et.al., 2009). Thus internal control can be considered as effective if it achieve the three main objectives as discuss earlier, which are reliability of financial reporting, efficiency and effectiveness of operations and compliance with law and regulations.

The primary objectives of an organisation's system of internal control are to provide administrative management with reasonable assurance that financial information is accurate and reliable; the organisation complies with policies, plans, procedures, laws, regulations and contracts; assets are safeguarded against loss and theft; resources are used economically and efficiently; and established objectives and goals for operations or programs can be met (Fadzil, 2005) .

Appropriate control is present when it can safeguard the company's asset and reliable financial reporting can be produced. Internal control system normally emphasized on reliable and relevant reporting. Risks would be identified and control procedures would be set up at every level of transaction and balance to ensure the company meets the transparent and timely objectives.

A good set of control would encourage efficient and effective use of company resources (Arens et.al. 2008). Every single process and operation would be developed with reasonable control to ensure all resources would be used at optimum level, manage to produce high quality product or services and at lower cost. Adequate control is also considered to be present if administrative management has planned and organised in a manner, which provides reasonable assurance that the organisation's objectives and goals will be achieved efficiently and economically. Reasonable assurance is provided when cost-effective actions are taken to restrict deviations, such as improper or illegal acts, to a tolerable level (Fadzil, 2005).

When the management set outs the company's objectives, the next important step is to identify risks that may occur in order to achieved that objectives. Ability to identify risk would assist the management to design needed control (Beasley, 2007). An effective control system is achieved when it can cater and mitigate the risk. Ability to manage the risk through appropriate control lead organisation to achieved its objective.

Assessment of risk should be in a form of systematic process and continuously because risk is constantly evolved. In assessing risk, management not only consider the likelihood of the risk occurrence but also predict the effect and it consequences and plan for preventive and corrective action. Effective internal control not only depends on its design, but also how the people inside the organisation implement and comply with it. A good design of internal control systems would not guarantee effectiveness if it failed to function properly at implementation level. For instance, unnecessary complexity of raw material acquisition process would lead to delay in production time, thus may incur higher cost to company.

Another important element in ensuring effective internal control systems is monitoring process. Since risk is alway evolve, regular and continuous monitoring of internal control systems by management team is needed. The control system that might be good today, but would no longer effective in future.

RESULT OF PREVIOUS STUDY

There are mix results can be found from the previous studies. Some of the studies provide positive insight of the effects of internal audit function to organisation. For example Fadzil 2005 suggest that internal auditors are best placed to understand and appreciate the business processes of a company and they act as management consultant to reduce risks. Internal auditors also help run a company more efficiently and effectively to increase shareholders' value. Internal audit effectiveness depending on identification of the basic objective of internal, define the goals to be accomplished by the internal auditing and establish measures assist towards the achievement of those goals. (Aguolu 2009, Dittenhofer 2001 as cited in Badara & Saidin 2013).

A study done by Munro & Stewart, 2011 shows that external auditors are willing to rely on internal auditors work which relate to internal control evaluation. It shows that internal auditors have done an effective role in evaluating and improving organisation's internal control system. However the same study found that, external auditors do not rely heavily on the substantive test conducted by internal auditors. Substantive testing relate with auditor's assessment of risk. Additional to that, the study also found that external auditor perceived internal auditor are more effective if there are strong business risk environment and strong reporting relationship with the audit audit committee. This finding is almost align with the finding on Fadzil, 2005, which internal audit department positively influenced the monitoring aspect of the quality of internal control system and illegal act. However, it is negatively influenced by the professional proficiency, objectivity and audit review of the internal auditing practices.

Besides that the performance of internal auditors also positively influenced the control environment of internal control system. A trained and competent internal auditor would manage to achieved related audit objectives thus consequently lead to positive impact on the control environment of the quality of the internal control systems since the senior management will demonstrate a higher climate of trust with better performance of the audit work.

There are also studies shows the problems faced by the internal auditors that may affect its own effectiveness. According to Ali et.al. 2013, the internal audit function in numerous statutory bodies and government-linked companies in Malaysia has a number of deficiencies i.e. a severe shortage of internal auditors, auditors with lack in skills in internal auditing, internal auditors operate in outdated modes of internal auditing.

Study by Arel, 2006 indicate that in-house internal auditor perceived to be less credible, less competence and less objective as compared to outsourced internal auditor. The external auditor prefer to use internal auditors as assistants than reliance on work already performed. Besides that, a study also found that internal academic audit process is less robust, particularly in terms of auditors selection and training (Blackmore, 2004).

Internal audit function in government sector is also found less effective due several issues such as lack of audit staff, inadequate support from top management, lack cooperation from auditee, insufficient training, experience and independence (Ahmad et.al. 2009).

PROPOSITION AND CONCLUSION

This paper try to identifies the effect of internal audit function towards internal control effectiveness. As mention earlier, internal control is divided into five components which are, control environment, risk assessment, control activities, information and communication and monitoring. Overall, based on findings from previous studies, internal audit would influence the internal control effectiveness especially in monitoring function. Main activities of monitoring function is reviewing whether the designed internal control systems is really implemented and report of illegal acts. The contribution of internal auditor in this part is recognised through reaction of external auditor whom willing to rely on internal auditor's report.

However, there is conditional situation for internal audit function to give positive impact towards other component of internal control system. Results of previous studies shows the need of internal audit to be effective first in influencing effectiveness of internal control. Internal auditor need to provide high quality audit work in order to positively influence the other four components of internal control systems. High quality audit work is an indicator that the internal audit function is effective. There are several factors identified as key contribution to internal auditor's effectiveness. One of the most importat factor is trust and support from top management. Understanding about roles and functions of internal audit department would create positive pattern of reaction by the top management. Support from the top management would give benefits to internal auditor. For example any recommendation and advise for improvement given to each department would be taken seriously since the staffs aware of attention given by the top management. Thus, indirectly would influence the attitude of other staffs.

Other important factor is sufficient resources given to internal audit department. Resources here is described as manpower, annual budget and proper workplace. These three elements not only enable the internal audit department to perform audit work better but also signify the relevance of this function in organisation. Completing the audit work with issues of understaff, underbudget and no proper office, definitely would not contribute to quality audit work. This problem again can be resolved if there is a strong support from the top management. Issues which relate with professional proficiency should also be addressed adequately. Internal auditor need to be given sufficient training, profesional education and qualification in order to ensure that they are able to perform this profession. Lack of knowledge and professional training would make the internal auditor fail to identify efficiently related audit objectives and relevant audit procedures to be conducted. Thus, would lead to ineffective audit recommendation.

Actively involved audit committee might be seen as a solution of independence and objectivity issues among internal auditors. Direct access of communication between internal auditors and audit committee members would reduce influence from management. Thus, enable the internal auditor to report any deficiencies occur and provide independence suggestion for improvement.

Improvement of all elements discussed above is also aligned with factors need to be considered by external auditors in relying the work of internal auditors as explain under International Standards on Auditing (ISA) 610. This standard requires external auditors to develop sufficient understanding and perform preliminary assessment of the internal audit function as well as its quality of work. Those factors are organisational status of internal audit in the entity; which focus on reporting structure of internal auditor, scope of function; describe the nature and extent of internal auditor's work, whether management take proactive actions on internal auditor recommendation, technical competence; internal

audit should be staffed with competent personnel with professional qualification, experience, and adequate training, and due professional care; whether the internal audit work is properly planned, supervised and reviewed.

High quality of internal audit performance could allow the external auditors to modify the nature and timing of audit procedures to be carried out. However, evidence from studies indicate that most of external auditors prefer to use report from internal auditors as part of additional information and use internal audit function just an assistant. This situation describe that the internal audit work still not fully effective.

Hence, in order to ensure an entity's internal audit department significantly affect the internal control systems effectiveness, top management should equipped internal audit function with all relevant factors that might contribute effectiveness to this department. Failure to empower internal auditors would lead to low quality audit work thus, will not positively influence internal control systems and its components. Clear understanding of internal audit functions and roles among all members of organisation is very important. This climate would develop believe and trust among them that internal auditing is a helpful tools that can bring the organisation move forward and achieved its goals.

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