

Comparative Study on the Factors Influencing on Effectiveness of Internal Auditing Practice between Private and State Banks in Eastern Province

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Abstract

This study investigates the factors influencing on the effectiveness of internal auditing practice among private and state banks in Eastern province. The factors influencing on the effectiveness of internal auditing practice are considered as independent variables, which are measured by using the dimensions of management support, auditor's competency and independency of internal audit unit. Effectiveness of internal auditing practice is considered as dependent variable in this study.

The data is collected from 120 internal auditing staff randomly using questionnaires sampling techniques from the banks in the Eastern province. The data is analyzed using statistical techniques of descriptive statistics, correlation, regression and cross tabulation analysis.

The findings of this study reveal that the level of effectiveness of internal audit practices and influencing factors are at high level among state and private banks. Further, this study shows the significant positive weak correlation between influencing factors and effectiveness of internal auditing practice. Therefore, the management has to focus on increase the quality of influencing factors for enhance the effectiveness of internal auditing practice in banking sectors in Eastern province.

Keywords: Internal Audit, Management Support, Competency of Auditing staff, Independency of Internal Audit.

Introduction

Internal control system is the important element in an organization (Gamage, Lock and Fernando, 2014). Internal auditing take place the important function of monitoring internal control in an organization. "Internal auditing means an appraisal activity established within an entity as a service to the entity (Sri Lanka Auditing Standard 610, ICASL, para. 3). In case of banking sector, the stakeholders are more concern over the effectiveness and transparent of financial control, since banks involve large amount of money transaction such as receiving deposits, providing loan as part of their everyday operation.

Due to the huge amount of money involved in banks, they need to have efficient and effective financial management mechanism in order to show their accountability to their stakeholders. So, it is expected that all the banks are supposed to maintain the accuracy and reliability accounting records.

The internal auditing unit plays an important role to maintain accuracy and reliability accounting records in an organization. Such as, monitoring of internal control,

examination of financial and operating information, review of the economy, efficiency and effectiveness of operations, review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements (Sri Lanka Auditing Standard 610, ICASL, para. 3). In this context, internal audit helps for the success of organization through better financial management.

The internal audit effectiveness is measured in term of internal auditors' ability to identify non-compliance activities with the office procedures and policies (Fadzil, 2005). This effectiveness of internal auditing practice depends on internal and external organizational environmental factors such as competency of auditing staff, independence of internal audit unit, and management support.

Cohen and Sayag (2010) ensured that management support is essential for the operation and success factor of internal auditing. Fernandez and Rainey (2006) stated that "it is not surprising that management support is key to effectiveness of internal auditing practice, as this factor has been found to be a crucial element in the success of other organizational process such as organizational change (Fernandez and Rainey, 2006) and quality improvement" (Dale and Duncalf, 1985).

In this context, this study focused to explore on the factors which influencing on the effectiveness of internal auditing practice. The study area is selected as banking sector, since it requires sound internal control mechanism. This study considers private and public banks in Eastern Province as a comparative study. Finding of this study could help to increase the quality of internal auditing practices in banking sector by identifying key factors influencing on the effectiveness of internal auditing practices. Further, this study support scholars to enrich knowledge in internal auditing practice in the banking sector.

Problem Statement

Quality of internal auditing practice is becoming a crucial part of accounting system in an organization to achieve its objective effectively. There are many factors influencing on the effectiveness of internal auditing practice in an organization (Cohen and Sayeg, 2010) and (Hung and Han, 2012). No studies have been taken as comparative study between public and private banks to identify the factors which influencing on the effectiveness of internal auditing practice in Eastern Province, Sri Lanka. Therefore the problem statement can be state as given below.

"What are factors significantly influencing on effectiveness of internal auditing practice among private and state banks in the Eastern province, Sri Lanka?"

Objectives of the Study

1. To find out the level of effectiveness of internal auditing practice among private and state banks in Eastern province.
2. To find out the level of influence of management support on effectiveness of internal auditing practice among private and state banks in Eastern province, Sri Lanka.
3. To find out the level of influence of auditing staff's competency on effectiveness of internal auditing practice among private and state banks in Eastern province, Sri Lanka.

4. To find out the level of influence of independency of internal audit unit on effectiveness of internal auditing practice among private and state banks in Eastern province, Sri Lanka.

Literature Review

Internal Audit

Internal auditing has been defined by authors is different from person to person. Larry and Bradley (1997) defined internal audit as an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The institute of internal auditors defined as “internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations”.

Objectives and functions of internal auditing

According to Association of Chartered Certified Accountants (2005 p.77), the internal audit function is responsible for evaluating, and commenting on the effectiveness of risk management, control and corporate governance process. Tawiah (2006) defined internal auditing as “Internal auditing is a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether:

- Financial audit and operating information is accurate and reliable,
- Risks to the enterprise are identified and minimized,
- External regulations and acceptable policies and procedures are followed,
- Satisfactory standards are met,
- Resources are used efficiently and economically, and
- The organization’s objectives are effectively achieved”.

Internal auditing activities

Tom (1972) has identified the following as the activities of internal auditing,

- Financial accounting that is, verifying, testing and reporting on the suitability of the financial audit accounting information periodically supplied to company management, including monthly, quarterly and six-monthly accounting reports on the company’s profits and financial audit position; reports on the company’s cash and credit position, including the inventory it has in store, in process, in transit and on order; and reports on production and sales levels.
- Management accounting that is, verifying, testing and reporting on the suitability of the periodic management and cost accounting information supplied to management, including monthly, quarterly and six-monthly cash forecasts; periodic budgets of company costs, revenues, profits and financial audit position; and statements of standard costs, and analysis of the variances which have arisen between the budgeted and actual costs, revenues and profits.
- Internal accounting control that is, verifying, testing and reporting on the effectiveness of the company’s system of controls, with particular reference to the various safeguards in operation to prevent loss of company assets and to ensure the effectiveness of its accounting data process.
- Operational effectiveness that is, verifying, testing and reporting on the effectiveness of the company’s operations which implement its policies and decisions affecting production, selling, administration etc. The strength of control

in these areas is also of concern. This part of internal auditing involves mainly non-accounting personnel, which distinguishes it from the previous three activities, which are mainly accounting in nature.

- Managerial efficiency– that is verifying, testing and reporting on the efficiency of company management, particularly the way in which it formulates its plans, policies and decisions. This again requires the use of mainly non-accounting experts.

Conceptual Framework

The study model consists of independent variable as influencing factors on effectiveness of internal auditing practice and effectiveness of internal auditing practice as dependent variable. Influencing factors on effectiveness of internal auditing practice were measured using the dimension of management support, auditing staff's competency and independency of audit unit. The details are shown in Figure 1.

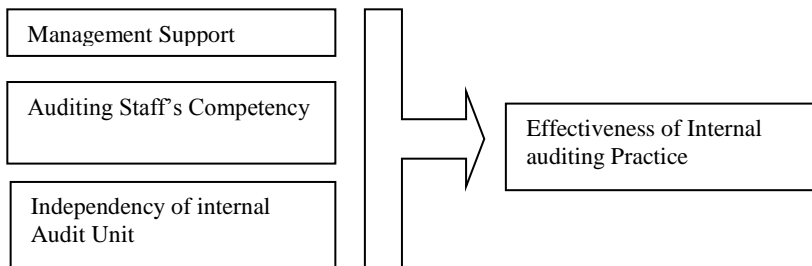


Figure 1: Conceptual Framework

Source: Baharud-din, Shokiyah, and Ibrahim (2014)

Management Support

Support of management have the certain impact for the effective functioning of internal audit (Baharud-din, Shokiya and Ibrahim, 2014). The success of internal audit function depends on the strength of management's support in the auditing process. Management have to recognize the internal audit process as perilous and important activity within the organization. Some study found that without management approval, support, and encouragement, the internal audit process is likely to face failure and worse time and money wasted. Ali, Ahmi, Gloeck and Shahdan (2007) found that, the effectiveness of the internal audit function in state and local government appears to be directly related to the management style of organization and their links, relationships and position in the internal audit contract.

Auditing staff's Competency

Proper internal audit staffing to the internal audit department and good management of that staff are keys to the effective operation of an internal audit. An audit staffs are professional who need to have sufficient education, training, experience and professional qualifications collectively to conduct the complete of audits required by its mandate (Al-Twaijry, Briefly and Gwillian, 2003). Auditors must comply with minimum continuing education requirements and professional standards necessitated by the

relevant professional organizations and its internal audit. It is ensured that the necessity for auditors who need to have a high level of education and diversity of skills required, which represents a major challenge to professional bodies, internal auditory institutions and management Bou-Raad (2000).

Independency of Internal Audit Unit

Organizational independency is a one of the factor which contribute to the effective government audit activities. In such manner, organizational independency is the need of audit activity to conduct work without interference by other factors or party for the audit task (Baharud-din, Shokiyah, and Ibrahim, 2014). The independence and objectivity of internal auditing depend on assurance services and consulting for the organization. Independence and objectivity are related closely where freedom that may threaten objectivity and no significant quality compromises in the audit service. Indeed, the audit activity need to have sufficient independence in order to conduct its work without interference.

Effectiveness of Internal Auditing Practice

Effectiveness of Internal Audit is defined by authors differently, where the term effectiveness refers to defined effectiveness as “the capacity to obtain results that are consistent with targets” (Arena and Azzone, 2009). Mihret and Yismaw (2007) defined internal audit effectiveness as “the extent to which an internal audit office meets its supposed objective or the extent to which it meets the intended outcome”.

The above two authors insisted to measure effectiveness of internal audit in terms of achieving the internal audit goals and objectives. Mihret and Yismaw (2007) described the characteristics of effective internal audit unit as given below.

- Undertakes an independent evaluation of financial audit and operating systems and procedures;
- Contributes to the achievement of organizational goals;
- Needs management’s commitment to implement recommendations;
- provides useful recommendations for improvements as necessary;
- Affected negatively by lack of attention from management which in turn adversely affects the auditee attributes; and
- Management support is a natural quid pro quo for effective internal audit.

Methodology

The data for this study is collected using questionnaires from the sample of 120 internal auditing staffs (internal auditors and internal control officers) of seven both private and state banks in the Eastern province, using random sampling techniques. The data is analyzed using univariate analysis, cross tabulation and bivariate analysis.

Univariate analysis is done by considering mean values and standard deviation of the variables. Such as the mean value of Management support for internal auditors, competency of internal auditing staff, Independency of internal audit unit and Effectiveness of internal auditing practice. The following decision criteria are used in this study.

If mean value fall between $1 \leq S_i < 2.5$: Low level

If mean value fall between $2.5 \leq S_i < 3.5$: Moderate level

If mean value fall between $3.5 \leq S_i \leq 5$: High level

Relationship between categorical variables is examined by using Cross tabulation analysis. And bivariate analysis techniques used for measuring the association between two variables (independent and dependent) for which Pearson' Correlation Coefficient is considered in this study. It indicates the strength of the linear relationship and its sign indicates the direction of relationship (David et al, 2007 cited in Paranthaman and Navaratne, 2010).

Simple regression analysis technique is used for the purpose of establishing the functional relationship between dependent and an independent variable in this study. This study considers multivariate analysis for measures the association when more than two independent variables exists. It is used to study the combined influence of the management support, competency of internal auditing staff and Independency of internal audit unit on the effectiveness of internal auditing practice. And multiple regression analysis technique is used for determine the functional relationship between a dependent variable and a host of independent variables (David et al, 2007 cited in Paranthaman and Navaratne, 2010).

Discussion

Level Influencing Factors and the Effectiveness of Internal Auditing Practice

The factors influencing on the effectiveness of internal auditing practice among private and state banks in Eastern province is measured using the dimension of management support, auditing staff's competency and independency of internal audit unit.

The level of influencing factors and effectiveness of internal auditing practice showed that over all variables are at high level both private and state. Comparing with private banks and state banks, the private banks have the highest mean value of influence factors than state banks.

Dimension of influencing factors on the effectiveness of internal auditing practice shows that management support for internal auditors and competency of internal auditors are at high level while independency of internal audit unit is at moderate level. The Table 1 shows the details.

Table 1. Level of influencing factors and effectiveness of internal auditing practice

Bank		Management support for internal auditors	Competency of internal auditing staff	Independency of internal audit unit	Influencing Factors	Effectiveness of internal auditing practice
State Bank	N	75	75	75	75	75
	Mean	4.1387	3.5089	3.2880	3.6452	4.0296
	Std. Deviation	.72929	.72280	.60738	.45335	.48409
Private Bank	N	45	45	45	45	45
	Mean	4.4889	3.6037	3.4044	3.8323	4.0148
	Std. Deviation	.60686	.65837	.76928	.43514	.56883
Total	N	120	120	120	120	120
	Mean	4.2700	3.5444	3.3317	3.7154	4.0241
	Std. Deviation	.70420	.69805	.67188	.45398	.51519

Relationship between Influencing Factors and the Effectiveness of Internal Auditing Practice

The relationship between influencing factors and effectiveness of internal auditing practice is weak positive correlation, significance at 0.000. The correlation between dimension of effectiveness of internal auditing practice, such as management support and independency of internal audit unit with the effectiveness of internal auditing practice also shows at positive weak correlations, significant at 0.05. Whereas the Competency of internal auditors have very weak positive correlation but which is not significance at 0.05. The details are shown in Table 2.

Table 2. Relationship between influencing factors and effectiveness of internal auditing practice

Influencing factors on the Effectiveness of internal auditing practice		Effectiveness of internal auditing practice		
		State bank	Private bank	Overall
Management support	Pearson	.680**	.016	.396**
	Correlation			
	Sig. (2-tailed)	.000	.917	.000
	N	75	45	120
Competency of internal auditing staff	Pearson	-.069	.139	.018
	Correlation			
	Sig. (2-tailed)	.558	.363	.847
	N	75	45	120
Independency of internal audit unit	Pearson	.196	.305*	.253**
	Correlation			
	Sig. (2-tailed)	.093	.042	.005
	N	75	45	120
Factors (overall)	Pearson	.415**	.253	.339**
	Correlation			
	Sig. (2-tailed)	.000	.094	.000
	N	75	45	120

Comparing with state and private banks, the management supports have strong positive impact on the effectiveness of internal auditing practice. Overall impacts by the factors shows that the state banks have moderate positive correlation, significance at 0.000. It is notable that internal auditing staffs' competency does not have significance relationship among both state and private bank even though auditors competency is at high level. It shows that lack of commitment of auditing staff or the pattern of internal auditing staff does not reflected on the effectiveness of internal audit practice.

Simple regression analysis shows that the management support has significant positive impact on the effectiveness of internal auditing practice among state bank, at the p-value 0.000 and the adjusted R square 0.455, indicates the 45.5% variation in the effectiveness of internal audit practice is explained by management support. And the independency of internal audit unit has significant positive impact on the effectiveness of internal auditing practice among private bank, at the p-value 0.042 with adjusted R square is 0.072.

Impact of influencing factors on the effectiveness of internal audit practice is analyzed using multiple regression analysis. It gives two models. The model 1 consider the factor of management support as a independent variable, with the beta value of 0.290, at 0.000 significance level, and it explain 15 % of variance on the dependant variable of effectiveness of internal auditing practice. The model 2 consider the factor of management

support and independency of internal audit unit as independent variables, with the beta value of 0.401 and 0.260, with the significance of 0.000 and 0.002 respectively. The model 2 explains 21.1 % of variance on the dependent variable of effectiveness of internal auditing practice. Since model 2 is the well predictor than model 1.

Table 3. Multiple Regression Analysis

Model	Variables	Unstandardized Coefficients		Standardized Coefficients	Sig.	Adjusted R Square	Sig. F Change
		B	Std. Error	Beta			
1	(Constant)	2.786	0.268		.000	0.150	0.000
	Management support	0.290	0.062	0.396	.000		
2	(Constant)	2.108	0.334		.000	0.211	0.002
	Management support	0.293	0.060	0.401	.000		
	Independency of internal audit unit	0.199	0.062	0.260	.002		

Conclusion and Recommendation

This study focused to exploring the factors which influence on the effectiveness of internal auditing practice among private and state banks in Eastern province. The influencing factors on the effectiveness of internal auditing practice are measured using the dimension of management support, auditor's competency and independency of internal audit unit. These dimensions are considered as independent variable and effectiveness of internal auditing practice is considered as dependent variable in this study.

Correlation and regression analysis shows weak positive correlation between influencing factors and effectiveness of internal auditing practice. Whereas, the management support have more positive impact than other dimension on the effectiveness of internal auditing practice. Especially, the management support has strong positive impact on state bank. While, independency of internal audit unit also have weak positive significance influence on the effectiveness of internal auditing practice in private banks. Hence, management should take necessary actions to increase management support by sufficient training to improve the auditing skill and full co-operation in order enhance the quality of internal audit practice.

In addition, the independency of internal audit unit also has to be ensured by the management to enhance the effectiveness of internal auditing practice since the study shows that independency of internal audit unit also has significant weak correlation. In this context, the internal auditors should be allowed to do the auditing activities without any interference from other staffs, bank should let them to freely decide the scope, time and extend of auditing procedures based on auditing standards, let them to freely access document, let them to examine auditing issue without any interest of other staffs and they should be provided power to express the opinions on financial statements.

However, the study found that, the competency of internal auditors have very weak positive influence on the effectiveness of internal auditing practice both state and private banks. Therefore, management should take necessary measures to enhance the commitment and involvement of internal auditing staff in such a way to enhance the

effectiveness of internal auditing practice in the banks. Further, the management needs to pay more attention that to empowerment of auditing staff, access to information and records, provide necessary resources to perform auditing activities allocating fund for relevant professional education to internal auditors.

The regression analysis reveals that the management supports explain alone 15% of variation on the effectiveness of internal auditing practice, whereas management support and independency of internal audit unit both have 21.1% variation as combined effect on the effectiveness of internal auditing practice. Therefore, management support and independency of internal audit unit are to be considered as important factor to enhance the effectiveness of internal audit practice in banking sector.

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