

The Effect of the Internal Audit and Firm Performance: A Proposed Research Framework

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ABSTRACT: This study attempts to propose a structure of the relationships between the internal audits characteristics (IAC); such as professional qualifications of the chief audit executive of the Internal Audit (IA), size, experience, and qualification; and firm performance. The presence of an internal audit department is significant as it is considered as the main element in employing accounting systems and this, in turn, assists in evaluating the department's work. The internal audit is deemed as the core of business accounting as it is the section that keeps track of all businesses associated with the sector. The internal audit efficiency assists in developing the company's work because the financial reports present the internal audit department's quality. In addition, an internal audit is a crucial part of corporate governance structure in an organization and corporate governance (CG) covers the activities of oversight conducted by the board of directors and audit committees to ensure credible financial reporting process (Public Oversight Board, 1994). Consistent with previous studies of the importance of internal audit, this study provides comprehensive oversights on the relationship between internal audit and firm performance. The past literature reveals there is a paucity of studies exploring the association between internal audit characteristics (IAC) and firm performance whether conceptual or empirical. The main objective of this study is to fill up the gap in the literature and provide an opportunity for future research to deeply to investigate this relationship.

Keywords: Internal Audit Characteristics (IAC); Agency Theory (AT); Resource Dependence Theory (RDT); Firm Performance (FP).

JEL Classifications: M40; M41; M42

1. Introduction

The internal audit department is very important inside a firm that the internal audit is regarded as the key element in the application of accounting systems which in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. The efficiency of internal audit helps develop the work of the company because the financial reports reflect the internal audit department's quality. Moreover, an internal audit is a significant part of the CG structure in an organization and CG encompasses oversight activities taken by the board of directors and audit committees to make sure that the financial reporting process is credible (Public Oversight Board, 1994). Three monitoring mechanisms have been highlighted in the CG literature, namely, external auditing, internal auditing

and directorship (Al Matarneh, 2011; Anderson et al. 1993; Blue Ribbon Committee, 1999; IIA, 2003).

The financial and corporate strategy of a company is underpinned by effective internal systems in which the internal audit has an important role in raising the reliability of the internal control system, improving the process of risk management and above all, satisfying the needs of internal users. The internal audit support enhances the system of responsibility that the executive directors and employees have towards the owners and other stakeholders (Eighme & Cashell, 2002). Taken together, the internal audit department provides a reliable, objective, and neutral service to the management, board of directors, and audit committee, while stakeholders are interested in return on investments, sustainable growth, strong leadership, and reliable reporting on the financial performance and business practices of a company (Ljubisavljević & Jovanovi, 2011).

2. Internal Audit function

Internal audit makes a large contribution to the achievement of company goals, and the implementation of strategies for their achievement (Ljubisavljević & Jovanovi, 2011). In addition, the internal audit function is responsible for reinforcing management and audit committee (Hutchinson & Zain, 2009).

Likewise, internal audit determines the reliability, reality, and integrity of financial and operational information that comes from different organizational units, on which appropriate business decisions at all levels of management are based. Successful implementation of internal audit tasks means that it must be independent, i.e., company management should in no way influenced by its work, information, conclusions, and evaluations. In this way the internal audit report becomes a means of communication between internal audit and management, and an important guideline for the successful management of the company (Ljubisavljević & Jovanovi, 2011).

Furthermore, the internal audit function facilitates the operation and effective working of the audit committee as the audit function goals are consistent with the former's financial reporting oversight responsibilities (Goodwin and Yeo, 2001; Goodwin, 2003; Scarbrough, Rama & Raghunandan, 1998). The creation of an internal audit function is supported by the governance reports (NYSE, 2002) and previous studies (Collier & Gregory 1996; Goodwin & Kent, 2003) as a mechanism to enhance internal governance processes.

Along this line of argument, Al-Shammari (2010) mentioned many factors of internal audit functions and they are provided below:

1. The internal control systems and arithmetic evaluations in an attempt to; ensure that the accounting system and internal controls systems are appropriate, ensure that the systems are suitable for the facility and propos system enhancements.
2. Assessing plans and procedures to determine weaknesses or defects in the systems and procedures used by the company and to propose modifications and enhancements needed, and to provide authority to the internal auditor for the examination of the aspects of establishment activity.
3. Taking into consideration the staff commitment to the company policies and procedures and therefore, internal auditor has to monitor these policies and procedures' implementation and to clarify them to the employees.
4. Safeguarding established funds as the development and implementation of systems is an attempt to make sure that the facility safeguards assets and funds against manipulation and fraud, to detect fraud and minimize losses stemming from neglect/abuse (e.g. loss of proper storage).

IAC in this study comprises four factors namely, qualifications of the chief audit executive, size, qualification and experience of the audit department. Generally, the previous study dedicated to examining the relationship between internal audit and firm performance is so limited in both developed countries and developing countries. Several studies have called for further studies to conduct extensive investigations; for instance, Hutchinson and Zain (2009), explored the association between internal (audit experience and accounting qualification) audit and firm performance (ROA) with growth opportunities and audit committee independence in the context of Malaysia. Their study has two future recommendations. First, future studies should examine the role of the board and the interaction between internal audit quality and audit committee independence. Secondly, this study

encourages future studies to look into alternate models of factors that would possibly impact IAQ and improve corporate governance.

There are some studies that have concentrated on problems concerning internal auditing in developed countries including the U.S. and the U.K. but little evidence is found in emerging markets. Hutchinson and Zain's (2009) study involved the examination of the relationship between internal (audit experience and accounting qualification) audit and firm performance (ROA) with growth opportunities and audit committee independence in Malaysia. They recommended future research to consider different factor models that may impact quality of internal audit and improve corporate governance. From this recommendation, the current study focuses on investigating the association between internal audit function and performance of firm both accounting measurement and market measurement while taking some new variables such as qualification of the chairman of internal audit, the internal audit size, experience of internal audit and internal audit qualification and consider moderators such as audit quality between internal audit and firm performance. More importantly, there is a lack of research in both developed and emerging nations concerning the direct relationship between internal audits functions with performance of firm. In addition to that, Al-Matari *et al.* (2012) investigated the relationship between board characteristics and firm performance in Kuwait. They recommended that future researchers examine the association between internal audit and firm performance whether directly or through a moderator. Moreover, the qualification of chairman of the internal audit is a new variable added by the present study.

In a related study, Davidson, Goodwin-Stewart and Kent (2005) investigated the relationship between internal governance structure comprising of board of directors, audit committee, internal audit function and the selection of external auditors, and earnings management in Australia. They used broad cross-sectional regression to test the association between independent variables and dependent variable. The sample comprised of 434 firms which were listed on the Australian stock exchange during 2000. The outcome disclosed no significant relation between the internal audit function and the choice of external auditors. In the same context, Ljubisavljević and Jovanovi (2011) studied the relationship between the roles of internal audit in Serbian firms. The sample comprised of 200 small and medium firms during 2011. This study used questionnaire survey and found that the effectiveness of the internal audit entity is weak.

Consistent with the above is Hutchinson and Zain (2009) who aimed to explore the relationship between internal audit quality (audit experience and accounting qualification) and firm performance (ROA) in Malaysia. The data were collected by a mail questionnaire among public listed companies in Malaysia during the period 2003. The results showed a strong relationship between internal audit quality and firm performance with opportunities of high growth and that this positive link is decreased by the increasing independence of audit committee. This study preferred an independent audit committee.

3. Internal Audit Characteristics and Firm Performance

3.1 Qualifications of the Chief Audit Executive and Firm Performance

In today's dynamic business environment, it is imperative that internal auditors are qualified as they should be thorough in their knowledge of business, systems, developments and other business topics. They should be able to decipher what works and what doesn't, the strengths, weaknesses of standards, code systems and procedures (Hala, 2003; Clikeman, 2003). In addition, the high quality profession of a chief audit executive is to improve the quality of audit and hence, the current study measured this variable through the questionnaire.

The head of internal audit qualified with auditing certification such as the Certified Internal Auditor (CIA), Certified Government Auditing Professional (CGAP), Certified Financial Services Auditor (CFSA), Certification in Control Self-Assessment (CCSA), and Certification in Risk Management Assurance (CRMA) where useful feedback for any mistake is provided. A certified auditor is able to make a good decision in the fastest time without having to wait or to consult with another team. The current study expects the qualification of a chief audit executive to absolutely enhance performance (Eighme & Cashell, 2002).

Firms that have undergone a period of strong performance may be in a more appropriate position to employ external directors. The prestige that an external director holds stems from various sources such as the director's title and the job position (D'Aveni, 1990). Moreover, those with higher

qualifications have backgrounds ripe with increased abilities in monitoring management and contributing to the strategic decision making (Hillman & Dalziel, 2003). These directors may also possess the potential to influence external resource providers including financial institutions and to signal firm value to investors. From this logical perspective and with a consistent recommendation as mentioned above, this current study considers the qualification of chief audit executive variable into account.

The majority of previous studies is focused on investigation of the qualifications of all members of the committee and their impact on firm performance, earnings management, audit quality and other in general. However, no study has examined the relationship between qualification of chairman in the internal audit committee and firm performance. Owing to the lack of literature review and consistent with Hutchinson and Zain (2009), the present study attempts to fill the gap by studying the relationship of member qualification with firm performance. Thus, the following proposition can be articulated:

H1: There is a relationship between qualifications of the chief audit executive and Firm Performance.

3.2 Size of the Internal Audit and Firm Performance

The second factor of IAC, which is the internal audit size (IAS), is essential to improve performance of companies. The size of internal audit is measured by the number of internal audit seating on the committee of the internal audit department.

In this section, the role of size in the committee is explained in light of different theories. First of all, Jensen's (1993) study seems consistent with Lipton and Lorsch (1992) who suggested the suitable number of board members to be seven to eight. Also, Firstenberg and Malkiel (1994) claimed that a board with eight to fewer members encourages greater concentration, participation and authentic interactions and discussion. Consistent with the above, Shaver (2005) argued that larger boards are often characterized by responsibility diffusion, which leads to social loafing, it encourages group fractionalization and minimizes group commitment to modifying strategy.

From the perspective of resource dependence theory, it postulates that larger board size would result in superior corporate performance owing to the various skills, knowledge, and expertise contributed into the boardroom debate. In addition, large boards could also offer the diversity that would assist companies to obtain critical resources and minimize environmental risks (Goodstein, Goodstein, Gautam & Boeker 1994; Ghazal, 2010; Pearce & Zahra, 1992; Pfeffer, 1987).

In another related study, Hutchinson and Zain (2009) explored the association between internal (audit experience and accounting qualification) audit and firm performance (ROA) in light of growth opportunities and audit committee independence in Malaysia. The sample was selected by two methods namely the questionnaire and secondary data from the annual report. It comprised of 60 firms listed on Malaysia Bursa during 2003. This study used multiple regressions to test the association between internal audit and firm performance. They recommended studying new factors of internal audit with firm performance. Due to their recommendation, the current study considers testing the quality of a chief audit executive and the size of the internal audit with firm performance.

Although the importance of internal audit inside a firm is confirmed, no study has considered examining the relationship between IAS and firm performance. Hence, the current study attempts to do the same and expects that the size of internal audit helps a committee to improve performance. Thus, the following is proposed for empirical investigation:

H2: There is a relationship between the size of the internal audit and firm performance.

3.3 Experience of the Internal Audit and Firm Performance

The third value of IAC is experience of internal audit. When a person has many years of experience, he/she can make a right decision, decide fast and deal with any situation. This variable is measured by the number of years the members have gathered through a questionnaire that is sent to every firm by email.

Consistent with the resource dependence theory and its proponents, expert individuals help in firm growth because they have a clear insight about how to deal with process and accomplish their tasks with superior quality. And when the firm provides a board with high experts, they help to understand external environment and as a result, will improve performance of companies.

There are few studies that examined the relationship between the experience of internal audit and firm performance in both developed countries and developing countries. There is also lack of

studies among the developing emerging markets. Few studies are discussed below in light of this association.

Hutchinson and Zain (2009) explored the association between internal (audit experience and accounting qualification) audit and firm performance (ROA) with growth opportunities and audit committee independence in Malaysia. The sample was selected by two methods namely questionnaire and secondary data from the annual reports. It involved 60 firms which were listed on Malaysia Bursa in 2003. This study used multiple regression analysis to test the association between internal audit and firm performance and found a significant relationship between experience of internal audit quality and firm performance.

Additionally, Prawitt, Smith and Wood (2009) examined the association between internal audit quality (experience and qualification) and earnings management. This study obtained sufficient data to estimate abnormal accrual models for 528 firm-year observations (218 unique companies) for the fiscal years 2000 to 2005. It used OLS regression to test the association between independent variables and dependent variable. The finding shows that a relationship between experience of internal audit and earning management.

As mentioned above, there is a lack of studies examining the relationship between the experience of internal audit and firm performance. Moreover, Al-Matari *et al.* (2012) recommended the re-examination of the relationship between the experience of internal audit and firm performance. Therefore, this study proposes the following.

H3: There is a positive relationship between the experience of internal audit and firm performance.

3.4 Qualification of the Internal Audit and Firm Performance

The fourth factor of IAC is the qualification of internal audit and it enhances the quality of internal audit. The member of internal audit who has high qualification can deal with any issue inside the department of internal audit. Hence, the present study attempts to measure the qualification of internal audit by questionnaire.

Consistent to agency theory and resource dependence theory and their proponents, qualified persons help to improve firm performance because they have a clear insight about how to deal with operation and achieve their work with high quality.

It is notable that there are only few studies that examined the association between the qualification of internal audit and firm performance both in developed countries and developing countries. There is also lack of studies among the developing emerging markets. Among the few studies of this caliber, Hutchinson and Zain (2009) explored the association between internal (audit experience and accounting qualification) audit and firm performance (ROA) with growth opportunities and audit committee independence in Malaysia. The sample was selected by two methods namely questionnaire and secondary data from the annual report. It comprised of 60 firms which were listed on Malaysia Bursa in 2003. They used multiple regression analysis to test the connection between internal audit and firm performance. The findings revealed a significant association between qualification of internal audit quality and firm performance.

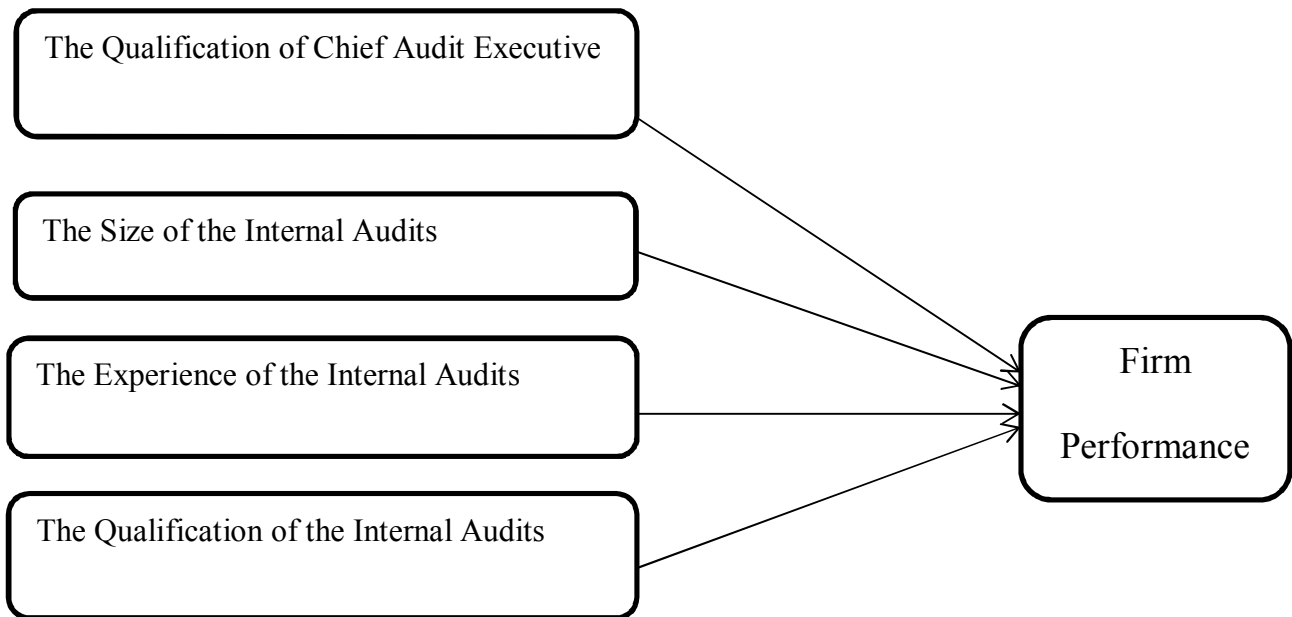
In another study, Prawitt *et al.* (2009) examined the association between internal audit quality (experience and qualification) and earning management. This study obtained sufficient data to estimate our abnormal accrual models for 528 firm-year observations (218 unique companies) for fiscal years 2000 to 2005. It used OLS regression to test the association between independent variables and dependent variable. The finding shows an association between qualification of internal audit and earning management. As stated above, there is a lack of studies that examined the relationship between the experience of internal audit and firm performance and as evidenced by Al-Matari *et al.* (2012). As such, the current study attempts to re-examine the relationship between the qualification of internal audit and firm performance. Therefore, the following hypotheses are proposed to be tested:

H4: There is a positive relationship between qualification of internal audit and firm performance.

4. Proposed Research Framework

Based on the limited literature regarding the effect of the IAC on the firm performance, this study proposed the following framework that is expected to explain a considerable amount of the variance in the firm performance (figure 1).

Figure 1. Theoretical research framework



5. Conclusion and Recommendations

The internal audit department is very important inside a firm where the internal audit is regarded as the key element in the application of accounting systems and this in turn, helps in evaluating the work of the department. The internal audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. The efficiency of internal audit helps develop the work of the company because the financial reports reflect the internal audit department's quality. In addition, an internal audit is considered as a significant part of the CG structure in the organization and CG covers the activities of oversight by the board of directors and audit committees to ensure credible financial reporting process (Public Oversight Board, 1994). Previous studies have attempted to provide a clear picture of the relationship between internal audit (professional qualifications of the chief audit executive, experience of internal audits and internal audit qualifications) and firm performance. The present study included the qualification of the internal audit's chairman. In theory, the present study is unique in its examination of the relationship between internal audit factors and firm performance.

There is a notable lack of research in developed as well a developing nations regarding the direct association of internal audits functions and firm performance. More specifically, among these few studies is the one conducted by Al-Matari *et al.* (2012) who investigated the association between the board characteristics and performance of Kuwaiti firms. They called for future researchers to examine the relation between internal audit and firm performance, both directly and indirectly, or in light of a moderating effect.

This study has many recommendations. First, the future researchers to empirically examine the effect of factors of internal audit on firm performance. Second, the future authors should employ this study in the developing countries considering the necessity of this type of research in this environment. More importantly, future studies could compare between two or more countries in the same economy and culture; for example in the Middle East or exactly in the gulf countries. Third, with respect to the importance of audit quality, the present research considers audit quality as a moderator between the association of audit characteristics and firm performance. This study reviews internal audit studies and found that only a few studies investigated the relationship between internal audit, firm performance and earning management. Last but not least, in consistent to the value of the integration between accounting-based measure and market-based measure together to enhance performance of firms to provide a clearer picture to investors, future studies should look into the how this integration should take place.

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