

**EFFICACY OF PAKISTAN'S INTERNAL AUDITING FUNCTION: A PERCEPTION
OF PAKISTAN'S EXTERNAL AUDITORS**

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Abstract

The current study explores the Internal Audit Function's (IAF's) possible significance in corporate governance. It must function well to support sound corporate governance. IAF has numerous stakeholders, including the Board of Directors (BoD) and external auditors. Every one of these stakeholders has unique requirements and perspectives regarding the IAF. We attempted to investigate how external auditors see the function and efficacy of IAF. Research conducted interviews with eight external auditors from various companies to achieve this. The results indicate that IAF's responsibilities include risk management, fraud risk management, and compliance and review of internal controls. This research also found that the IAF's current role may be more effectively performed by granting it independence and appointing persons with the necessary training, expertise, and experience. An efficient IAF can also aid external auditors.

Keywords: *Corporate Governance, Board of Directors, Internal Audit Function, External Auditors*

Introduction

Since the Enron scandal, the significance of sound corporate governance has grown, and every company is now prioritizing it (Kotb et al., 2020). To decrease false and misleading financial reporting, identify and prevent material weaknesses, enhance the internal control environment, and reduce the risk of fraud, the importance of IAF has grown (Shakeel et al., 2020).

Because the IAF is primarily relied upon by governance stakeholders, it is becoming important (Mertzanis et al., 2020). These stakeholders would only rely on IAF reports or information if they thought the organization's quality could have been more effective. One of the pillars of corporate governance is also believed to be external audit, especially in preventing and

identifying financial statement fraud and inaccuracies. (Adamec, an external auditor is seen as a significant IAF stakeholder because an effective IAF results in higher-quality external audits at cheaper fees.

External auditors examine IAF before audit purposes, even though there needs to be more common knowledge of the quality of IAF. Competency, objectivity, and completed work are often the three main factors considered when evaluating quality. It is crucial to gain insight into the factors influencing IAF quality and how various stakeholders assess it. Improved IAF quality boosts the confidence of the external auditor, which can raise the external audit's efficacy and efficiency. The external audit's charge is also lowered due to the external audit assignment's time savings. Effective collaboration between internal and external auditors promotes sound corporate governance, reducing the likelihood of a company failing. Though the importance of IAF in sound corporate governance has grown, very few studies have looked at this function's efficacy. Sulub et al. (2020) proposed that parties, depending on IAF work—the management, the external auditor, or the Audit Committee (AC)—should be considered. The authors proposed that the quality could differ depending on who utilizes the IAF's work. Given the significance of IAF, it is important to comprehend its role, effectiveness, and the traits that can enhance its efficacy.

The study's primary objective is to investigate how external auditors view function and IAF efficacy. Research also looks for characteristics that can increase IAF's effectiveness and investigates how IAF benefits external auditors.

The function of IAF has been the subject of several studies (Sulub *et al.*, 2020; Shakeel *et al.*, 2020; Al-Yazidi et al., 2022). The corporate environment has seen numerous changes in the last few years due to the expanding need for and difficulties associated with the function of IAF. IAF's responsibilities include risk management, governance, and control. Only when it is effective can the IAF provide value (Khan et al., 2020). Given the IAF's expanded consultation function, evaluating the IAF's efficacy is crucial (Walker et al., 2022). External auditors use the work of IAF to make modifications to audit methods. Efficient Internal Audit Functions (IAF) can reduce external auditor workloads and lower audit fees (Erzurumlu & Avci, 2020). Finally, but just as importantly, this study looks for the characteristics that could make the IAF role most effective.

IAF is a requirement for listed businesses operating in Pakistan (Shakeel et al., 2020). This study is the first in Pakistan's internal auditing industry. Since there are not only a few studies on external auditors' perceptions of the function and efficacy of IAF, this one fills the research gap by examining the topic.

Literature Review

The research has examined the role of IAF from several angles, as demonstrated by Mertzanis et al. (2020) measurement of the relationship between management and quality. Evaluations were found in six areas: impartiality, expertise, education, accreditation, monetary focus, and corporate support for the program. They came to the conclusion that IAF quality moderates earning management. Khan et al. (2020) investigated the role and impact of IAF in Malaysia's public sector. Data for this research was gathered from various individuals companies employ in internal audit roles. They concluded that the IAF needs to receive more support from high management. Al-Yazidi et al. (2022) examined how the IAF disclosed material vulnerabilities in the companies' internal control frameworks. They used the information from 214 US companies for this reason. The study's findings demonstrated a negative correlation between the educational attainment of those participating in IAF and disclosures of material weaknesses. Sulub et al. (2020) studied the IAF's role in supporting effective corporate governance in Kenyan banks. They employed surveys to gather information, and 89 people answered them. They discovered that the audit function is crucial and beneficial in fostering corporate governance competence.

Sulaiman et al. (2022) examined the connection between corporate governance and internal audit in Pakistan. The qualities of internal audit quality and corporate governance were significantly correlated in this study, which used questionnaire responses to gather data.

Several studies were conducted to determine the effectiveness of IAF's engagement. Cohen and Christensen (2022) analyzed IAF's effectiveness in Israeli institutions. Data was collected from 180 organizations. According to the findings, the primary elements determining the IAF's efficiency are its independence and top management's support and priority level.

The findings indicated that IAF required regulatory function and did not contribute value. Numerous studies (Madawaki, 2020; DeSimone & Rich, 2020; Prasad et al., 2021) have examined

the qualities and traits that may enhance the effectiveness of IAF while also examining the effectiveness and efficiency of the IAF. Five chief audit executives from South African stock exchange corporations were interviewed. They suggested focusing more on audit procedures to enhance IAF through the risk-based audit methodology. Attempted to assess IAF in Nigeria's public sector. According to the study's conclusion, IAF needs to be more effective in public sector organizations, which was reached via questionnaire methodologies for data collecting. When researchers studied organizational variables that determine the success of IAF, they discovered that audit team traits, audit procedures, and links impact IAF's effectiveness.

Chen et al. (2020) investigated the composition and traits of the IAF in Egyptian businesses. He examined organizational circumstances, interactions with external auditors, and the insourcing or outsourcing of IAF. According to the study, these companies' internal audit departments need more independence and maturity.

Walker et al., 2022 and Ali & Ali (2022) looked at the elements contributing to the IAF's ability to participate in good corporate governance actively. Using replies of 782 chief audit executives from diverse US corporations, it was discovered that IAF is critical to strong corporate governance. Evaluated the variables that affect the IAF's efficacy. Business managers and internal auditors provided information for this study, which focused on the Saudi corporate sector. In his most recent study, he examined the performance evaluation of IAF in Vietnamese construction companies. He concluded that those employed in the IAF needed to gain the necessary skills and training. He conducted interviews and reports to gather the data. According to the findings, many organizations needed an appropriate mechanism for measuring IAF performance. Examined a different study of the variables connected to the IAF's efficacy in the Greek corporate environment. A postal survey was utilized to collect data, and the findings show that the variables that determine the IAF's performance include quality, competency, team independence, and management support. A mailed survey was used to gather data, and the findings indicate that the following criteria influence the efficacy of the IAF: independence, competency of the team, quality, and management support.

Investigated the standards that external auditors employ in assessing a company's IAF. They used Malaysian business information issued by the Big 4 audit firm. They discovered that external

auditors rely on internal audits; technical proficiency and function scope are the most important factors. Khan et al. (2020) looked into how many external auditors depend on externalized internal audit functions while internal auditors also offer non-audit services to the company in another study. Data came from eighty-nine auditors working for various US audit companies. The study's findings indicate that internal auditors' objectivity is severely impacted when they offer non-audit services. This situation also impacts how much the exterior auditor depends on audit work.

Methodology

This kind of qualitative study is exploratory. Structured interviews were employed in order to gather information. Researchers who conduct this kind of research frequently employ this methodology (Čular et al., 2020; Balakrishnan et al., 2021). Because of elasticity, structured interviews allow researchers to examine research discovered during interviews (Adeniji, 2021).

Participants

Purposive sampling is used in this study, and only those willing to provide extensive information are chosen for interviews. Among the participants were senior employees of audit firms. Seven audit firm partners and one Big Four audit firm director were interviewed. In qualitative research, choosing a sample size that produces data with a reasonable probability of attaining theoretical saturation, data saturation, or informational redundancy is important. Purposeful sampling is more suitable (Baatwah et al., 2021).

The interviews were done in Lahore between May and June of 2017, with a duration of 12 to 15 minutes per interview. Interviews were conducted using a conventional interview guide.

Interview Questions

A literature review and various theories of service quality measurement from other disciplines were used to construct interview questions.

Validity and Reliability Issues

Interviews are recorded to guarantee the data's validity and dependability (Lee & Yu, 2021). Since this is an exploratory study, we taped the interviews and took quick notes of ideas and thoughts throughout them. Immediately following the interview, we elaborated on these notes.

Discussion

IAF is responsible for assessing internal control, risk supervision, fraud risk administration, and validating compliance. All respondents agree on these duties of IAF. "It (IAF) advises the organizations on matters such as the acquisition of new ventures, evaluation of controls, and whether controls are effective or not?" stated one of the replies. "IAF does internal control evaluation and also finds out the root causes of the happening of the issues," stated a different respondent. According to the respondents, the primary duties of IAF include ensuring that internal controls comply, evaluating them, and offering recommendations for improvement.

One of the responders made the following statement about the IAF's risk management function:

The IAF had little to do with risk management when it emerged in the 1980s and 1990s. It was restricted to Adherence to rules and regulations. Because of the increase in size and volume of organizations after 2000, the IAF was required to verify everything and cooperate in an important risk management role.

Financial frauds present an extra difficulty for firms. Although fraud detection is not the IAF's primary duty, respondents view fraud risk management as one of the agency's responsibilities. They only notice warning signs and the possibility of deception. One respondent stated, "IAF identifies fraud risk and sees the fraud from that angle; IAF sees the red flags but does not directly detect fraud." In the words of one respondent who agreed with this statement: "With a thorough study and extensive assessment of controls, it (IAF) can detect fraud, but it requires a unique setup. They frequently do not assist in the identification and detection of fraud. However, they do recognize it when an issue comes up and there is a warning sign.

However, according to one of the responders, the IAF is also in charge of detecting fraud; he stated, "Detection of fraud becomes the responsibility of IAF."

Respondents said that IAF needs to do the above roles more efficiently. Respondents stated it could be better at carrying out the roles above. Regarding IAF, our corporate sector needs to view it correctly. "In Pakistan, there should be a risk-based role of IAF, but it is not like this," stated another respondent. This situation can be attributed to several factors, including how businesspeople view the IAF, its lack of independence, inadequate support from upper management, and the fact that it is seen as a cost rather than a value-adding role. One of the respondents stated that enterprises are either family-owned or, in the case of listed enterprises, family-dominated. IAF's ability to perform management functions is limited. They answer to management, who are the ones who are meant to be assessing them. One more respondent stated, "Our owners saw the IAF as just another expense. Only some people wish to invest in IAF because they have the correct perception. However, one respondent notes an exception to this rule: "They are playing a good role in big companies like multinationals." One more respondent discussed the need for the IAF to operate effectively. He declared: "That relies on the degree of freedom and authority organizations grant IAF via a charter that the authorized committee and the board of directors authorized. The IAF's ability to manage risks will increase if it is autonomous, has some authority, and has the necessary tools and expertise. External auditors' scope and nature of work differ greatly from internal auditors. However, if IAF operates well, it facilitates external audits. One Participant stated that when this duty is carried out well, it would benefit the the external auditor. The external auditor must expand the scope of the figures test in the absence of the IAF. According to a different answer, "IAF can reduce the extent of substantive procedures performed by external auditors if it is strong and fulfills the quality parameters." This could shorten the duration of the external audit and result in a lower audit price. The efficiency of IAF's work and the accessibility of all reports for external auditors are key factors in reducing the workload of external auditors. Another respondent's thoughts on this matter are included below; he stated: "The extent of the work of the external auditor would be reduced if the external auditor receives a reasonable assurance that the IAF is operating as intended and its reports are shared with the external auditor, demonstrating that the IAF covered those areas and their conclusion is satisfactory." Given how valuable the IAF's work is, what qualities contribute to its effectiveness? According to respondents, appropriate training, top-level management support, open communication with the audit committee and board of directors, and independence can all help to

ensure that internal audit functions effectively. One Participant stated that the IAF should be granted a charter, some authority, and a Terms of Reference (TOR). The IAF receives the duty from its board of members, which appoints the Audit Committee. This could work via proper skill set—staff competencies, and diverse experience. According to the respondents, the characteristics of IAF staff are contingent upon the roles played by the organizations and the regions they serve. Someone with a degree of information, expertise, and experience should oversee the IAF function. The Participant stated: Most importantly, it is an ideal function led by a competent individual. Audit players are in charge of various concerns that are considered essential competence to complete the audit. Regarding the head of the IAF role, Participant stated: "The head of the IAF needs to be properly qualified in the field and keep up with the latest developments." He needs to be informed of changes in his field and his business. Knowledge unique to the industry is also required. Professionals with relevant training, a well-rounded skill set, and relevant, varied experience should make up an IAF team. IT proficiency is also a critical competency. Respondents stated that members of the IAF needed to be knowledgeable with software solutions such as SAP and Oracle Financial and IT functions. "IT and information system audit is a part of IAF," stated one respondent. It is a highly valued and necessary skill for the IAF. The IAF should have the following qualities: autonomy, power, direction, open communication, and Audit Committee (AC) support. It should also report solely to the AC. One of the participants stated: "The IAF has to be autonomous. The AC should provide the IAF instructions. There will be no CEO over IAF. Only AC should be accountable to the IAF. The AC should approve the audit plan. "Though IAF needs to link to the board of directors," stated a different respondent. In publicly traded firms, the AC was involved. The Audit Committee should hear from the IAF. One of the interviewees underlined the significance of educating firm management about the efficacy of the IAF. He stated: "To make IAF effective, a culture transformation is required. A movement in culture entails a change in how top management and other staff members are perceived, as nobody likes being examined or criticized. People feel that the International Audit Office and the outside auditor criticize them. However, the IAF does not function in this manner. IAF aims to enhance you and guide you in finishing the assignment.

Conclusion

The IAF offers several advantages to all stakeholders, including policy and procedure compliance inspections, internal control evaluations, risk supervision, and fraud protection. IAF's present role could be more effective. We can make it more successful by strengthening and independentizing the IAF and bringing in professionals with the necessary training, expertise, and background. Suppose the IAF operates efficiently within the company. In that case, the external auditor would benefit from its operations, reducing the time and effort required for an external audit.

Limitation & Future Direction

We cannot generalize the study's findings because participants were chosen only from the Pakistani community. Our analysis focused solely on external auditors' perceptions of the IAF; other stakeholders who were left out may have different views on the program's efficacy. The following are potential areas for further investigation based on this work: Semi-structured interviews were employed in this study to collect data; however, alternative methods such as questionnaires and case studies may also be used. Another study could also learn how additional stakeholders—who are not included in this research—perceive the quality of the IAF. It can also be argued in further studies how the IAF's sourcing arrangement impacts the external auditors' quality judgment.

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