



## Factors Contributing to the Effectiveness of Internal Audit: Case Study of Internal Audit in the Public Sector in Kosovo

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### **Abstract**

Since audit has a great importance in preventing, consulting and finding cases of funds misuse, it was thought of analyzing the factors that contribute to increasing the efficiency of internal audit in the public sector which would help to set proper and more transparent governance of public financial resources. This study investigated the relationship between effectiveness and contributing factors. The data for the study were collected through an online questionnaire and direct hand-outs of such. The results of the empirical analysis proved that effectiveness has a positive relationship with internal audit quality, the competence of the internal audit team, the independence of internal audit, as well as with the support of internal audit from the management. Moreover, it was confirmed that audit quality is the fundamental element of the effectiveness of internal audit since it was among the most influential factors in the sample.

## 1. Introduction

The importance of internal audit in preventing, consulting and finding cases of funds misuse and also the need to strengthen this important pillar in a place like Kosovo is crucial. Therefore, a study that analyzes the factors that contribute in raising the quality, the internal audit credibility in the public sector was considered necessary. This study will help in better and transparent governance of public finances.

Given that the Kosovo government is the largest and principal employer and the institution that allocates public funds, namely the budget for all budgetary organizations, it needs a functional mechanism of responsibility to give special attention to the management of public finances in accordance with the applicable law. Internal audit is a very important element in public sector governance, as it supports the role of government oversight, insight and foresight (Goodson, Mory, & Lapointe, 2012). According to this source, internal audit is the key to good governance of public finances. Maintaining adequate resources properly in the right amount for a period of time enables the management to achieve governmental objectives within the organization. Considering that high quality in financial public management leads to the accomplishment of governmental activities, Kosovo under UNMIK Regulation 1999/16 established the internal audit department in the framework of the Central Fiscal Authority. Earlier this institution was responsible for creating the basis of legislation and audit of all state budgetary units. Internal audit is an independent, advisory system designed to establish the objective safety and to improve the quality of the organization's activities in order to add value to the organization. The responsibility of the internal audit is to assist the management in detecting and assessing the risk of various abuses that contribute to the improvement of the control system in the organization (CHU Audit Internal N. t., 2011). Based on the importance of internal audit in proper governance, this paper will focus on analyzing the factors that contribute to the effectiveness of internal audit in the public sector in Kosovo (Finance, 2016). Studies undertaken by other researchers considered that these are the elements that contribute in increasing the efficiency of internal audit in an organization: quality of internal audit, competences of the

internal audit team, independence of internal audit, and the support of internal audit by the management.

The purpose of this research is to analyze the link between the effectiveness of internal audit and the four factors that were pointed as contributing factors in the effectiveness of internal audit, such as: quality of internal audit, competences of the internal audit team, independence of internal audit, and the support of internal audit by the management. The second purpose of this paper is to investigate the common impact of these factors on the effectiveness of internal audit which would help the government in correct and more efficient management of public money.

This research is divided into seven sections and is structured as follows: the first section includes the introduction followed by literature review. The third section entails theoretical treatment of internal audit, followed then by three sections where the research methodology, empirical analysis and conclusion are presented. The bibliography is included in the final section.

## **2. Literature review**

“Internal audit is a cornerstone for good governance in the public sector” (Goodson, Mory & Lapointe, 2012).

According to (Badar, 2012) internal audit has to do with the examination of accounting records in order to verify their accuracy and compliance with all applicable legal requirements, accounting standards, professional statements and organizational policies. The above mentioned study indicates the internal auditor is an additional guarantee for financial controls in the public sector and is responsible for the audit of all financial transactions by examining all accounting books and records held in the organization, in order to detect fraud and correct errors.

Internal audit is an integral part of the system of internal control. It is carried out within the organization with the main objective to increase the value of the organization and improve its operations. (Vokshi, 2015)

Other authors (Dr A.O. Enofe, Dr C.J. Mgbame, V.E. Osa-Erhabor, AJ Ehiorobo, 2013) consider internal audit as a very important element in the range of resources and mechanisms available to public sector managers, which helps in fulfilling accountabilities in front of citizens.

With the increasing size and complexity of the public sector in recent years, the importance of internal audit has increased. It is today a major factor in determining the quality of internal control in the public sector. Its development has made a significant contribution to improving public sector management (Angus Unegbu Okechukwu, Mohammed Isa Kida, 2011).

Internal auditors must have the relevant factors or characteristics such as competence, independence and have the support of management, in order to be effective (Amanuddin Shamsuddin<sup>1</sup> et al., 2015).

Relying on (Amanuddin Shamsuddin et al., 2014) internal auditors often have a negative relationship with the auditee in the public sector. Without a decent support from the auditee, internal auditors will have difficulties in completing the audit process which will definitely affect the effectiveness of internal audit.

In developed countries, the audit committee has the role of a mediator between the management and internal audit. This makes the role of management support less important than in developing countries, where audit committees are new. This issue is controversial even in developed countries, the executive management is directly in a position, or indirectly through the audit committee, and it affects to a certain degree the nature of work of the internal audit. When the management considers the internal audit function as positive, then the function is likely to be more effective (Alzeban Abdulaziz, David Gwilliam, 2014).

Even (Aaron Cohen & Gabriel Sayag, 2010) consider the support of the management almost crucial to the successful internal audit functioning. Other determinants that contribute to the effectiveness of internal audit depend on the support of top-management as hiring skilled staff in internal audit, developing career paths for the internal audit staff, ensuring

organizational independence for the work of internal auditors, result as decisions made by senior management.

(Nasibah Halimah Ahmad et al., 2009) listed lack of audit staff as the main problem that internal auditors face in conducting an effective internal audit. The study also qualified as essential the competence of internal audit, objectivity and quality of work performed. Otherwise, the internal audit function will face difficulty in achieving its effectiveness. The importance of internal audit itself, which adds value to management accountability by providing safety focused on risk and advisory services, demonstrable by economic indicators, efficient and effective, encouraged many authors worldwide to analyze the factors that will contribute in increasing the effectiveness of internal audit (Kosum Ali, Skender Breznica, Afrim Shala, Kimete Afiri, 2016). In their research "Factors that contribute to the effectiveness of internal audit in the public sector" (Zulkifli Baharud-din, Alagan Shokiyah, Serjana Mohd Ibrahim, 2014) included 330 respondents from the internal audit departments of ministries. The authors confirmed that there exists a significant positive correlation between the effectiveness of audit and audit competence, independence and support by the management audit. Other authors (Dr A.O. Enofe, Dr C.J. Mgbame, V.E. Osa-Erabor, A.J. Ehiorobo, 2013) analyzed the role of internal audit on the effectiveness of public sector management and confirmed that the local government can achieve effective management and that internal audit plays an important role in efficient management of the public sector. A research on the effectiveness of the internal audit conducted by (Salehi, 2016) offered evidence that competence, the size of the department of internal audit, communications between internal auditors and external independence of internal auditors, and the level of management support for conducting internal audit. All these contribute to the effectiveness of the internal audit department. Almost all studies set the same factors as contributing in the effectiveness of internal audit and all have proved the hypothesis raised that contributing factors impact and are crucial to the effectiveness of internal audit.

### **3. Theoretical treatment of the development and importance of internal audit in Kosovo**

Although internal audit has its beginnings in earlier times, in Kosovo it started functioning since 2000 due to past occurrences. Based on the UNMIK Regulation 1999/16 the Internal Audit department was established in the framework of the Central Fiscal Authority. At this

time the internal audit was centralized and was tasked with creating the legal and sub-legal as well as auditing of all public institutions in Kosovo. After 2003 the issue of internal audit was regulated by the Law on Public Financial Management whereby the Internal Audit Department was established upon the request of this Law within the Ministry of Economy and Finance. Nowadays, in Kosovo almost all public institutions have created capacities for internal audit. However, for an effective internal audit, the challenge of the country remains the empowerment and development of employees of the internal audit and also the support of this department by high level management, to advise the management on the operation of control systems, their adequacy and provide a reasonable and objective assurance that public funds are economically, effectively and efficiently used (Ministry of Finance, 2016). Relying on the self-evaluation report submitted to the Central Harmonization Unit of Internal Audit, Kosovo has in total 151 internal auditors in public sector, 97 of them are of the central level, while 54 independent agencies are of the local level. The Central Harmonization Unit for Internal Audit from 2009 until 2011, jointly with CEF Ljubljana has organized trainings and exams for auditors of public sector where 32 auditors were certified by CIPFA Great Britain. Whereas in the second phase of the certification program CIPFA certified 35 auditors (Kosum Ali, Skender Breznica, Afrim Shala, Kimete Afiri, 2016). Now, the Central Harmonization Unit for Internal Audit made all preparations including trainers and modules (literature) for certification of internal auditors who are not certified yet.

#### **4. Methodology and research hypotheses**

The data for this paper were collected through a questionnaire which consisted of 27 questions divided into six sections. The first section included the respondents' demographic data, while the sections from two to six analyzed the dependent variable, the effectiveness of internal audit and independent variables, quality of internal audit, competences of internal audit team, independence of internal audit and support of internal audit by the management. The questions that determined these factors were proven through factorial analysis by the author (Drogalas George, Karagiorgos Theofanis, Konstantinos Arampatzis, 2015). For these sections was used the five-point scale assessment method by Likert: 5 - completely agree, 4 agree, 3 neutral, 2 disagree, 1 disagree. The econometric model in the paper set the following

dependent variables: the effectiveness of the internal audit influenced by four independent variables such as quality of internal audit, competences of the team of internal audit, the independence of internal audit and support of internal audit by the management:

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \mu$$

Y = the effectiveness of internal audit

X1 = audit quality;

X2 = powers of the audit team;

X3 = the independence of internal audit;

X4 = support from the management audit;

$\beta$  = coefficient of regression;

$\mu$  = coefficient of errors

The research population consists of all internal auditors in the public sector in a total of 151. The size of the sample was determined through formula (1) where into account was taken the number of internal auditors in the public sector.

$$M_m = \frac{\frac{Z^2 \cdot p \cdot (1-p)}{e^2}}{1 + \left(\frac{Z^2 \cdot p \cdot (1-p)}{e^2 \cdot N}\right)} \dots \dots \dots (1)$$

where:

Z = the value of the coefficient of reliability (in this case the accuracy of the paper is 95%, so the tables have z = 1.96):

Source : <https://www.surveymonkey.com/mp/sample-size-calculator/#>

p = 0.5 is used for the necessary sample size,

N = size of population (in this case is 151)

e = confidence interval, expressed in decimals (e.g., 0.1 = ± 10%):

$$Mm = \frac{\frac{Z^2 \cdot p \cdot (1-p)}{e^2}}{1 + \left(\frac{Z^2 \cdot p \cdot (1-p)}{e^2 \cdot N}\right)} = \frac{\frac{1,96^2 \cdot 0,5 \cdot (1-0,5)}{0,1^2}}{1 + \left(\frac{1,96^2 \cdot 0,5 \cdot (1-0,5)}{0,1^2 \cdot 151}\right)} = \frac{\frac{3,8416 \cdot 0,5 \cdot 0,5}{0,01}}{1 + \left(\frac{3,8416 \cdot 0,5 \cdot 0,5}{0,01 \cdot 151}\right)}$$

$$= \frac{96,04}{1,6360} = 58,70 \approx 59$$

From the calculations of this formula show that the number of the sample for the study was 59, margin of error was  $\pm 10\%$  provided with a 95% level of confidentiality. The results calculated by the formula are also verified by an online calculator in the following link (<https://www.surveymonkey.com/mp/sample-size-calculator/>).

The questionnaire was sent to 59 respondents, while responses were obtained online through google survey and direct hands-out of such. 21 of the respondents were of the local (municipal) level, while 38 were central and independent agencies. The distribution of the samples for the study between local and central levels was calculated depending on their share in the population. The data shows that 64% (97 of 151 auditors were of the central level) whereas the local level participates with 36% (54 of 151 auditors were at the local level). If this form of calculation is taken into consideration then the total sample for the study, 38 must be from the central level ( $59 * 64\% = 38$ ), while 21 must be taken from the local level, respectively auditors in the municipalities of the Republic of Kosovo ( $59 * 36\% = 21$ ). The respondents were selected randomly, while their answers created a database that was processed with the SPSS program.

#### 4.1 Research hypotheses

The purpose of this research was to find a link between the effectiveness of internal audit as a dependent variable and four other variables: quality of internal audit, competences of the team of internal audit, the independence of internal audit, audit internal support from the management and the impact of these factors on the effectiveness of the audit. Testing and verifying the raised hypotheses will be achieved through correlation and linear regression.



**H1: The effectiveness of internal audit is positively correlated with the quality of the internal audit;**

**H2: The effectiveness of internal audit is positively related to the competences of the internal audit team;**

**H3: The effectiveness of the internal audit is positively related to the independence of internal audit;**

**H4: The effectiveness of internal audit is positively correlated with support from the management audit:**

## **5. Descriptive and empirical analysis**

### **5.1 Empirical analysis of the research**

The statistical report below shows that 55.9% or 33 of respondents were males and 44.0% or 26 were females. While the age of the respondents had this distribution: 3.3% or 2 are aged 25-30 years old, 18.6% or 11 are aged 31-40 years old, 35.5% or 21 are aged 41 -50 years old, the majority of the respondents belong to the latter category over 51 years, which constitutes 42.3% of the total sample, or expressed in number 25 of 59.

69.4% of the respondents are BA graduates, while 28.8% are MA graduates. If we analyze the structure of the job position in the public institution, 54.2% hold the position of director of the internal audit in the public sector, while officials of internal audit constitute 45.7% of the total. On the other hand, regarding the work experience of the respondents, the first category of 0-1 year has no respondents, while the three other categories are almost proportional in participation, from 1- 5 years of experience comprise 30.5%, 5 - 10 years comprise 35.5%, and the final category over 10 years comprises 33.8%.

**Table 1.** Characteristics of respondents

<b>Variables</b>		<b>Frequency</b>	<b>Frequency in %</b>
<b>Gender</b>	Male	33	55.9%
	Female	26	44.0%
<b>Age</b>	25 – 30 years	2	3.3 %
	31 – 40 years	11	18.6 %
	41 – 50 years	21	35.5 %
	Over 51 years	25	42.3 %
<b>Level of education</b>	Faculty	41	69.4 %
	Master	17	28.8 %
	PhD	0	0 %
	No answer	1	1.7 %
<b>Position respondents</b>	Director of internal audit	32	54.2 %
	Audit official	27	45.7 %
<b>Work experience</b>			
<b>Working experience in an institution</b>	0 - 1 year	0	0.0%
	1 – 5 years	18	30.5 %
	5 – 10 years	21	35.5 %
	Over 10 years	20	33 8%

**Source:** Calculated by the author

Starting from the descriptive analysis on the effectiveness of internal audit, it can be concluded that respondents considered as important the role of internal audit in increasing the value of the organization and also in the improvement of the performance not only of departments, but of the entire institution. From results regarding the quality of the audit we can confirm that respondents considered that the audit report was correct and the findings of the audit were conferred correctly. Among the elements which present audit quality,

respondents have assessed with the lowest points the communication between internal and external audit. Among the elements which present audit quality, respondents have assessed with the lowest points the communication between internal and external audit. The competence of the audit team is rated very high by respondents. Most of the respondents value the education of adequate internal auditors, they also consider internal auditors as professionals and proactive. From the results we understand that communication between external and internal auditors could increase even more.

Over 50% of respondents have estimated that internal auditors are independent in reporting to higher levels within the institution. However, the results display that auditors should participate more in the development of processes within the institution.

The end of the descriptive analysis shows the results of the Internal Audit Support from the Management. These results indicate that the management is very well informed about the needs of the audit, yet it should support the audit personnel more. Respondents also estimated that the audit department is not big enough to carry out their work efficiently.

### **5.2 Description of the empirical results and hypotheses testing**

The above raised hypotheses will be tested through the empirical results. The hypotheses will be tested through this correlation – the Pearson coefficient in report with the dependent variables: effectiveness of internal audit with the independent variables such as: quality of internal audit, team competence, independence and the support of the internal audit by management within public institutions in Kosovo. The results of the regression analysis will be presented in this empirical analysis.

The results of the effectiveness of internal audit with the quality of internal audit show that these two variables have a link between them since the coefficient of significance  $p = 0.000$  is less than 0.05, which means that there is a relationship in between them. While the Pearson coefficient shows the strengths of the connection between them, from Table 2 it can be seen that  $r = 0.566$  which means that these two variables have a strong link as  $r > 0.49$ , and also by signs of understanding the connection between them is positive, proving so H1. The result of the effectiveness report with the competence of internal audit presented in Table 3 confirms a strong, significant, positive connection between these two variables ( $p = 0.000 < 0.05$ ;  $r = 0.604 > 0.49$ ), results which confirm H2.

Hypothesis number four is set to support internal audit of the management of public institutions, where in this case the analysis of correlation confirms H4 (( $p = 0.000 < 0.05$ ;  $r = 0.566$ ), showing that the effectiveness of internal audit has a positive significant relationship with the support of internal audit management (Table 4).

Lastly, the results in Table 5 confirm a positive correlation between the effectiveness of internal audit and internal audit independence ( $P = 0.051$ ,  $r = 0.255$ ), keeping in force H3, but the link has not the same level of significance like other hypotheses.

**Table 2.** Effectiveness report on internal audit quality

<b>Correlations</b>			
		<b>Effectivity</b>	<b>Quality</b>
<b>Effectivity</b>	Pearson	1	.566**
	Correlation		
	Sig. (2-tailed)		.000
	N	59	59
<b>Quality</b>	Pearson	.566**	1
	Correlation		
	Sig. (2-tailed)	.000	
	N	59	59
<b>**.</b> Correlation is significant at the 0.01 level (2-tailed).			

**Source:** Calculated by the author

**Table 3.** Effectiveness on internal audit competence

<b>Correlations</b>			
		Effectiveness	Competence
<b>Effectiveness</b>	Pearson	1	.604**
	Correlation		
	Sig. (2-tailed)		.000
	N	59	59
<b>Competence</b>	Pearson	.604**	1
	Correlation		
	Sig. (2-tailed)	.000	
	N	59	59
<b>**.</b> Correlation is significant at the 0.01 level (2-tailed).			

**Source:** Calculated by the author

**Table 4.** Relation between effectiveness and support from the audit management

<b>Correlations</b>			
		Effectiveness	Support
<b>Effectiveness</b>	Pearson	1	.449**
	Correlation		
	Sig. (2-tailed)		.000
	N	59	59
<b>Support</b>	Pearson	.449**	1
	Correlation		
	Sig. (2-tailed)	.000	
	N	59	59
<b>**.</b> Correlation is significant at the 0.01 level (2-tailed).			

**Source:** Calculated by the author

**Table 5.** Relationship between effectiveness and independence of internal audit

Correlations			
		Effectiveness	Independence
<b>Effectiveness</b>	Pearson	1	.255
	Correlation		
	Sig. (2-tailed)		.051
	N	59	59
<b>Independence</b>	Pearson	.255	1
	Correlation		
	Sig. (2-tailed)	.051	
	N	59	59

**Source:** Calculated by the author

### 5.2.1 Regression Model

F- test explains the relation between the independent variables through values of tolerance and VIF values. From the results presented in the table below, it can be seen that the lowest value of tolerance is 0.510, which means that it is higher than the allowed value 0.10 and the highest value of VIF is 1.959 which is also lower than the acceptable value 10. Since the values are within the permitted boundaries shows the model is thus acceptable, reaffirming that the independent variables have no correlation with each other.

**Table 6.** Impact factor variance F-test

Model		Collinearity Statistics	
		Tolerance	VIF
<b>1</b>	(Constant)		
	Quality	.583	1.716
	Competence	.510	1.959
	Independence	.771	1.297
	Support	.582	1.719

**Source:** Calculated by the author

In table 7 the values  $R = 0.657$ ,  $R^2 = 0.432$  and Adjusted  $R^2 = 0.390$  are introduced. If the adjusted  $R^2$  is converted into percentage, it can be concluded that 39% of the changes in the effectiveness of internal audit could be explained by the independent variables.

**Table 7.** Assessment Model

<b>Model Summary<sup>b</sup></b>				
<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>
<b>1</b>	.657 <sup>a</sup>	.432	.390	.41436
<b>a. Predictors: (Constant), Support, Independence, Quality, Competence</b>				
<b>b. Dependent Variable: Effectiveness</b>				

**Source:** Calculated by the author

The following results present the statistical values of the independent variables in the model. Beta coefficient for the independent variables is: internal audit quality of 0.390, competence of internal audit team 0.396, internal audit independence 0.019, and internal audit management support is 0.071. From these results it can be concluded that the highest impact on the effectiveness of internal audit based on the level of the coefficient Beta has competence of internal audit team and internal audit quality, while two other variables independence of internal audit and internal audit management support do not have a significant impact.

While the coefficient sig which is presented in the last column of Table 8, shows that the competence of internal audit team and internal audit quality have a  $p < 0.05$  coefficient, it means that their contribution has a high statistical importance on the effectiveness internal audit. However, the two other variables have values of the Sig.  $p < 0.05$  coefficient confirming that the contribution of these two variables on the effectiveness of internal audit does not have a high statistical significance.

**Table 8.** Assessment of each independent variable in the equation

Coefficients <sup>a</sup>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
		<b>1</b>	(Constant)	.858		
	Quality	.390	.179	.293	2.180	.034
	Competence	.396	.156	.365	2.540	.014
	Independence	.019	.099	.022	.188	.852
	Support	.071	.106	.090	.667	.507
<b>a. Dependent Variable: Effectiveness</b>						

**Source:** Calculated by the author

## 6. Conclusion and recommendations

This paper investigated the relationship and impact of the quality of internal audit, the competence of audit team, independence and support of the internal audit with the effectiveness of internal audit. The results confirmed that these factors have a positive relationship with the effectiveness of internal audit which can come to a conclusion that the public sector of internal audit if: audit quality is at an appropriate level, the team of auditors has the competence and independence in their work and is also supported by the management, then audit is effective anyway; something that would also contribute to a better management of public finances in the country.

In general, the results of respondents were positive for all analyzed elements: audit quality, competence of the audit team, the independence of internal audit and internal audit support from management. Nevertheless, there are some exceptions where respondents gave negative ratings (slightly disagree, disagree, neutral). Based on these results it is recommend for the internal audit in the public sector in Kosovo to improve further the communication between internal audit and external audit, attention should be paid to the participation of



internal auditors in continuous trainings. It remains to be desired also for a higher participation level of internal auditor's in development processes within institutions. A further improvement of reporting to the highest ranks within the public institutions will contribute even more to the effectiveness of internal audit in the public sector in Kosovo.

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