

THE ROLE OF INTERNAL AUDIT ACTIVITY IN ACQUIRING EXTERNAL AUDIT SERVICES: AN EMPIRICAL STUDY OF BANKS

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Abstract

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The role of internal auditing has received significant attention from researchers in the recent past. Due to its enormous contribution to the banking system, it has been used extensively to support other governance processes. The objective of this research paper is to explore how internal audit activity plays a role in the acquisition of external audit services in the national banks of the United Arab Emirates (UAE). Internal audit activity and external audit services represent a dynamic process of the corporate governance process. The study uses both qualitative and quantitative data to determine the role that internal auditing plays in the acquisition of external audits. The data is collected from 27 national banks in the UAE using questionnaires, hence it gives the opinions that people have about auditing as well as the figures of respondents. The study aimed to understand how the functions of internal audits contribute to the acquisition of external audits. The main contribution of this study is supporting the arguments that auditing researchers have not been fully responsive to the issues associated with changes in internal audit, services that may be offered, and internal audit's growing function (Hayek, 2013).

Keywords: Audit Services, Banks, Internal Audit, External Audit

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1. INTRODUCTION

It has become quite a difficult task to run a successful business (Ghayas & Siddiqui, 2012). This is primarily because the increased level of competition has made it extremely difficult for businesses to survive (Khan, Ghayas, & Kashif, 2019). Therefore, businesses must improve their processes, especially the processes of financial reporting (Amran, Lee, & Devi, 2014). Hence, the increasing

need for financial reporting and compliance in the banking sector has increased the role of auditing as a function of corporate governance (CG).

Effective CG has been gaining greater public and regulatory attention in today's competitive economy, with the internal audit function playing an important role in CG. This increased focus aligns with public concern about the high amount of fraud that has been widely publicized among businesses. In this context, CG refers to rules, laws, and orders

that affect the firm's management and control. It is made up of a set of guidelines that assures that the company's interaction with its shareholders is transparent and fair (Al Matari & Mgmml, 2019).

A good corporate governance system is designed to reduce information asymmetry, allowing businesses to operate more effectively and efficiently, allowing them to achieve their goals. An effective company structure must offer effective protection to stakeholders so that they can persuade themselves to effectively retrieve the advantages. The system must also aid in the creation of a positive and long-term environment. Internal audits are meant to encourage corporations to execute a competent corporate governance framework to the fullest extent possible, allowing the company's aims to be better directed and its operational activities to function more efficiently (Putra & Mulya, 2020).

Although the scope of internal audit differs from that of external audit, they are both complementary functions that ensure corporate governance of the organization. The corporate governance system comprises four pillars that interact with each other for the competence and efficiency of the company's activities, these include management, external auditor, audit committee, and internal audit.

In this context, internal audit plays a significant role in the acquisition of external audit services. Because of this, internal audit is considered a fundamental function in the new developments, in governance, and in safeguarding the efficiency of the internal control. The purpose of this study is to provide an insight into the role played by the internal audit departments in the selection of external audit services in UAE's national banks.

The existing governance environment has further led to the augmented importance of the association between internal and external auditors. The purpose of such change is to confirm that even if the management selects an external auditor, it should be done after getting confirmation from the audit opinion of the company (Keating, Gordon, Fischer, & Greenlee, 2003). Moreover, companies while conducting financial audits annually have to decide whether to appoint their previous auditor again or select any new auditor. The reason for the dilemma is the appointment of a new auditor involves formal processes including an audit committee and a competitive tender whereas reappointment may involve either a similar organizational process or just an informal procedure. However, whatever the choice, the necessity is to gather the information regarding the suitable criteria for the evaluation of potential audit firms, which may contain various direct as well as indirect costs (Sands & Huang, 2002). Thus, appointing an external auditor is not a piece of cake, consequently, the responsibility should be given to the parties that have the caliber to do it efficiently and successfully such as internal auditors.

Auditing services are an integral part of an array of services offered by a large proportion of professional accounting firms. Companies that need to engage an accounting firm to provide professional auditing services are faced with the problem of deciding whether to re-appoint the incumbent auditor or appoint a new auditor (Olowookere & Inneh, 2016).

Hiring an external auditors firm comes with various benefits making the process unavoidable. To summarize, the purpose of it is mainly to increase the high-quality financial reporting to avoid the problem of asymmetry of information flow between a firm and the finance provider which eventually ends up in the reduction of cost of capital. Although, the hiring of an external auditor is a tiresome task as it may include some hidden as well as direct costs like direct costs incurred in arranging the clients' assistance for the auditors or indirect costs in the form of insecurities related to the high degree information attached to the company's financial statements. However, in recent times the role of internal auditors has changed and thus includes more involvement in the improvement of possibilities to attain the firm's objectives, by an instance, identifying the operational changes to be made or by reducing the risk exposures using assurance missions and consultation.

In addition to the enduring concern of external audit, the other side also includes a fact that as the internal audit activity has an established place in the organization and normally has a broader scope of work approving ready integration of the new function and so internal auditor considering internal sources of knowledge and expertise, can help the company's management in the process of appointing the external auditor. Thus, the problem of the study is represented by the following research question:

RQ: Do internal auditors play a role in the acquisition of external audit services?

The internal audit function contributes to the improvement of auditing quality as well as managerial support and organizational improvement within an organization. It assists in the management of self-evaluation methods that aid in the development of organizational competencies. It helps with organizational development (Alam, Mohammed, & Khan, 2021).

Many researchers have investigated how many external auditors rely on internal auditor functions. As a result, the purpose of this study is to improve on prior research by examining the role of internal auditors in the acquisition of external audit services in the UAE.

The remainder of the paper is organized as follows. A brief review of the study on the subject involving internal and external auditors is included in Section 2. The research approach is then presented in Section 3. The following Sections 4 and 5 present and discuss the findings. The conclusion is presented in Section 6.

2. LITERATURE REVIEW

In their research, Regoliosi and Martino (2019) examined the extent of operational cooperation and activity coordination between internal audit departments and auditing firms. Mutual collaboration, according to the findings of this study, increases the reliability of controls and, at least in part, eliminates duplication of work. These findings are especially pertinent in light of the growing importance of internal audit as a key corporate governance mechanism and the new challenges that external auditors encounter as a result of increased audit requirements.

Eulerich and Lenz (2019) investigate the integration of the internal audit function (IAF) into the organizational governance structure of nine different businesses, identifying best practices and organizational variances in order to improve overall governance quality from the perspective of IAFs. According to the researchers, maintaining a worldwide firm in today's economic environment is a difficult task, especially given the continuously changing environment and new and unforeseen threats. Given this complexity, it's logical that management lacks the resources, particularly time and skill set, to oversee every aspect of the organization. Delegating this duty to the IAF to detect inherent risks and produce added value through their observations and advice is a typical practice.

Hegazy and Stafford (2021) examine the roles of the internal and external auditors, as well as their relationships with the audit committee, in two different English public sector environments. The study demonstrates that the work of the internal audit (IA), external audit (EA), and audit committee (AC) is well triangulated. However, close interaction between EAs and ACs, as well as responsibilities crossing over, might create a conflict of interest and raise major issues about the EA's independence and objectivity.

Putra and Mulya (2020) investigated the impact of internal audit quality on the effectiveness of good corporate governance, as measured by auditor independence, professional capabilities, the scope of work, and examination. Internal audits are expected to motivate organizations to develop a robust corporate governance framework to the fullest extent possible, allowing the company's goals to be more directed and operational activities to run successfully and efficiently, according to the study.

The significance of the role of internal auditors in the acquisition of external auditing services has placed a great emphasis on the need to use internal auditing activities. Harrington (2004) states, in his study, that the internal audit department role is not confined to the accounts department but rather is spread in every field of the workplace as it helps in the internal control of every bank structure. Although it can be criticized, the internal audit division implements its activities in all the administrative, financial as well as operational processes.

Hossain, Lim, and Tan (2010) and Hamdallah (2012) in their study, examined the consequences of corporate governance on the company's choice of an external auditor. They established the relationship between governance and auditor's choice by way of consequences that happened through the country's legal environment. The outcome of their study showed an optimistic approach between corporate governance and auditor's choice considering a strong association with the country-level legal protections. To be more precise, the study proved a strong positive association between corporate governance and auditor's choice when the country's legal environment is robust and thus is the case vice-versa. Overall, the investigation suggested that the assistance provided by the high-quality auditors is likely to be greater when the legal environment is strong because both auditors and firms are subject to more severe legal penalties for opportunistic behavior.

Hayek (2015) states, in his research, that there is an association between some corporate governance characteristics and external audit fees. The researcher used independence of the board of directors, independence of the audit committee, accounting financial expertise of the audit committee, use of internal audit, annual meetings of the board of directors, accounting and financial expertise of the board of directors, annual meetings of the audit committee to measure the corporate governance characteristics. The research confirmed the importance of strengthening the external auditing function and corporate governance mechanisms at public companies.

In their exploratory research work, Sands and McPhail (2003) explained the choice and standards businesses use in the auditor selection procedure for listed Australian public companies. Their work is primarily based on international literature and tries to develop a more inclusive study to minimize the limitations acknowledged in those overseas studies. The researchers have identified eight constructs from their literature review and then pragmatically tested them through a national survey. Data were analyzed by choosing nine choice criteria. Out of nine, the two most important criteria recognized were technical competence and client orientation. Literature eventually suggested that the direct and indirect costs which a company suffers may affect the importance of selection decision choice criteria. A thorough comparison between companies newly selecting the auditors and those that are re-appointing the incumbent audit firm proved that the remaining criteria were of equal importance for the selection and re-appointment choices. Nevertheless, the results at the end recommended the criteria as level of audit fee and effective preparation and communication of audit submission are significantly more vital for companies engaging a new auditor.

Abbott and Parker (2000) threw some light on the function of the audit committee in auditor selection. The writers claimed that vigorous and autonomous audit committee members demand a high level of audit quality due to the concern of financial as well as goodwill loss which may result from lawsuits or SEC sanctions. The article further claimed that the auditors who specialized in the client industry are usually more productive and of high excellence than those who are not. Thus, we can easily infer from their study that an audit committee that is more independent and active is more likely to engage an industry specialist auditor. Tate (2007) talks about the non-profit organization's choice regarding auditor selections. The main theme of the article revolved around the concept of the factors responsible to change the company's auditor and the factors responsible to select the auditor when those changes are made.

Due to the importance attributed to internal auditors, their roles and duties concerning external auditors have gradually increased. UAE's reliance on the function of internal auditors has been researched extensively. Glover (2013) conducted a study to determine the impact that internal audit has on external audit. The study concluded that internal audit is extensive and has played a role in the collaboration process. As a result, it enhanced the ability to acquire external audit services. From the organizational and operational perspective, it is evident that external auditors' ability to be acquired by internal auditors, relies on how internal

auditing function is significantly affected by how internal audit activities are organized. The extent of reliance is greater when the structure and role of the internal audit function are more formal. Specifically, the extent of reliance is positively related to the extent of the scope of the internal auditors' work, the size of the internal audit function, measured by the number of personnel and internal audit hours worked, and the amount of expenditure on internal audit.

Thus, it is evident that an internal audit's ability to enhance cooperation is significant. Another research by Bather and Burnaby (2016) evaluated the reliance of the internal auditors on the external auditors. In the study, the authors highlighted that the work of internal audit in establishing work ethic and style of corporate governance gives them the ability to fulfill their governance and stewardship towards the acquisition of external auditors.

One of the most relevant studies that evaluated this topic in developing countries is the research that was carried out by Al-Sukker, Ross, Abdel-Qader, and Al-Akra (2018). The objective of the study was to investigate the extent to which external auditing reliance on the work performed by internal auditors and to determine the factor that influences the ability of internal auditors to collaborate with external auditors. In the research, the author also investigated how the competence and workers' performance by internal auditors affected their ability to acquire external auditors. The study concluded that the major factors that influenced external auditors' reliance decisions are the capability and work performance of the internal auditors. Additionally, the researcher also determined that the most important factor that determined the ability of the internal auditors to acquire external auditors was the client's size (Al-Sukker et al., 2018). When the external auditors can run a large bank, it implies that they can meet the functional purpose of the internal auditors. As a result, this increases their ability to attain corporate governance. Another study that was carried out in the banking sectors of developing countries, was that by Mihret and Admassu (2013). The study investigated internal auditing and its cooperation in the context of corporate governance. According to the study, UAE's dependence on internal auditor input is a concept from the West and has been unsuccessful in affecting external auditors. According to the study, the quality of the work done by internal auditors is the main factor that influences external auditors' reliance decisions. Furthermore, apart from the issue of external auditors, the researchers proved that improving the quality of the internal auditors leads to quality corporate governance and encourages cooperation between external and internal auditors. Considering the research by various scholars, it is evident that the role of internal audit activity is essential in the acquisition of external audit services.

3. RESEARCH METHODOLOGY

3.1. Research sample — Questionnaire

Primary data is obtained by way of conducting the first-hand survey. The survey data consist of responses to the questions that were intended for directors of the internal audit department from 27 National Bank of the UAE. Since the questionnaire consists of Likert-type items that fall into the ordinal measurement scale, descriptive statistics

recommended for ordinal measurement scale items include a mode or median for central tendency and frequencies for variability (Ary, Jacobs, & Sorenson, 2010). Additionally, analysis procedures appropriate for the researched ordinal scale items will also include the Chi-square measurement.

A research questionnaire is used to collect data from the Heads of internal audit departments from 27 national banks in the UAE. Data collection takes about two months using this method. The appropriate set of responders received questionnaires. A total of 27 questionnaires that may be used were returned and examined.

Five auditors and three academics assessed the questionnaire's research validity. Two of the external auditors who reviewed the questionnaire have a professional certificate in external audit, and three of them are CPAs (Certified Public Accountants). The three professors are from the Accounting Department of the Higher Colleges of Technology (the UAE). The questions were then pilot-tested by five outside internal auditors. These five pilot questionnaires were not included in our data analysis. As a result, some wording adjustments were made to some items.

Cronbach's alpha is used in this study to determine the reliability of the questionnaire based on the inter-correlations between the measurement items (Burns & Burns, 2008). Cronbach's alpha is 0.8 for all constructs. This signifies that the data is consistent and reliable internally. Descriptive statistics were used to analyze and interpret the data collected from a sample of 27 questionnaires.

3.2. Model

The following table provides descriptive statistics regarding the variables used to measure the role of internal audit activities in the acquisition of external audit services.

Considering the above literature review, eight variables were selected to be considered in this research. The first variable *ADV* represents the extent of advisory services provided by the internal auditors for the selection and retention of external audit services.

The second experimental variable *PLCH* evaluates the role of internal auditors in examining the appropriateness of policies for the selection and retention of external audit services.

The third variable *PRTSR* apprehends the internal auditor's participation in the selection or retention of external audit services.

The fourth variable *MNGSR* weighs the excellence of the management process of internal auditors while conducting the selection or retention policy related to external audit service.

The fifth variable *ADTSR* is designed to articulate the internal auditor's process of auditing for the selection and retention of external auditors.

The sixth variable *MTRQ* is intended to quantify the monitoring of ongoing service qualities of external auditors by the internal auditors.

The seventh variable *CWC* includes the assessment conducted by internal auditors for the external auditors' compliance with the terms of service contracts and other agreements periodically.

The last, eighth variable *ASIND*, is the observation of the participation of internal auditors in the assessment of independence provided to the external auditors.

Table 1. The operational definition of variables

<i>Variable</i>	<i>Definition</i>
<i>ADV</i>	Advisory services provided by the internal auditors for the selection and retention of external audit services.
<i>PLCH</i>	The internal auditors' role in examining the appropriateness of policies for the selection and retention of external audit services.
<i>PRTSR</i>	The internal auditors' participation in the selection or retention of external audit services.
<i>MNGSR</i>	Internal auditors' management process excellence when conducting the selection or retention policy for external audit services.
<i>ADTSR</i>	Articulate the internal auditors' process of auditing for the selection and retention of external auditors.
<i>MTRQ</i>	Quantify the monitoring of ongoing service qualities of external auditors by the internal auditors.
<i>CWC</i>	The assessment conducted by internal auditors for the external auditors' compliance with the terms of service contracts and other agreements periodically.
<i>ASIND</i>	Observation of the participation of internal auditors in the assessment of independence provided to the external auditors.

4. RESULTS

Table 2 shows that the highest mean reached 4.00 out of 5 for item *PLCH* "The role of internal auditors in examining the appropriateness of policies for the selection and retention of external audit services". Then, for item *PRTSR* "The internal auditor's participation in the selection or retention of external audit services", by high agreement degree (mean 3.95). Next, for item *ADV* "The extent of advisory services provided by the internal auditors

for selection and retention of external audit services", by high agreement degree (mean 3.89). The lowest mean was 3.68 for item *MTRQ* "Weights the excellence of the management process of internal auditors while conducting the selection or retention policy related to external audit service" by a high agreement degree. The total mean for item "The role played by the internal audit departments in the selection of external audit services in UAE's national banks" domain reached 3.85 by a high agreement degree.

Table 2. Descriptive analysis

<i>Variables</i>	<i>Median</i>	<i>Standard deviation</i>	<i>Range</i>	<i>P-value</i>
<i>ADV</i>	5	5.899152482	14	0.001069
<i>PLCH</i>	3	8.35463943	20	0.000255
<i>PRTSR</i>	3	5.770615219	15	0.0002385
<i>MNGSR</i>	6	5.366563146	12	0.003892
<i>ADTSR</i>	6	6.14817046	15	0.003892
<i>MTRQ</i>	6	5.366563146	12	0.0832645
<i>CWC</i>	6	4.449719092	12	0.001063
<i>ASIND</i>	6	3.911521443	9	0.014305

Table 3. Mean and standard deviation for "managerial performance" domain items and total means of them (n = 27)

<i>Variables</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Rank</i>	<i>Agreement degree</i>
<i>ADV</i>	3.89	5.89	3	High
<i>PLCH</i>	4.00	8.35	1	High
<i>PRTSR</i>	3.95	5.77	2	High
<i>MNGSR</i>	3.84	5.36	4	High
<i>ADTSR</i>	3.76	6.14	7	High
<i>MTRQ</i>	3.68	5.36	8	High
<i>CWC</i>	3.83	4.44	6	High
<i>ASIND</i>	3.79	3.91	9	High
Total means	3.85	5.33		High

5. DISCUSSION

This paper investigated the role played by the internal audit departments in the selection of external audit services in UAE's national banks.

Panels in Table 3 above indicate that the contribution of an internal audit for acquiring external audit service through the chosen scales is perceived to be somehow satisfactory. The median provided by the internal audit is at the moderate level with the least value of *PLCH* and *PRTSR* followed by *ADV* and then the rest of the variables. It is further observed that the model has explanatory power where the p-value shows significance at 1% and 5%, proving a strong relationship between both the independent variables with the dependent variable. Moreover, noticing the pattern of mean and standard deviation, all the individual variables have a positive coefficient proving that the chosen criteria

support the activities of internal auditors to acquire the services of external auditors. This reinforces the findings of Al-Sukker et al. (2018) and Mihret and Adamssu (2013) that internal auditors play a pivotal role in obtaining the services of external auditors. The findings of this study add to and expand on previous research, providing more information on the correlation and collaboration between internal and external audit functions. The findings of this study support Regoliosi and Martino's (2019) findings, particularly regarding the growing importance of internal audit as a corporate governance mechanism. The findings of this study support the argument that audit integration between internal and external auditors is critical for avoiding duplication of efforts and repetition of work between the two parties. As a result, the two parties save time, work, and have a more comprehensive overview of the institution's activities (Jabbar, 2018).

Internal auditing is a critical part of successful organizations conducting a number of tasks connected to internal auditing (Alam et al., 2021) to enhance corporate operations and activities. Internal auditing aids in the improvement of auditing quality within an organization as well as management assistance and organizational improvement. It aids in the control of self-assessment procedures that aid in the improvement of organizational competences. It aids in the improvement of organizational objectivity as well as the enhancement of organizational value. It also aids in the attainment of organizational objectives as well as the possession of skills, knowledge, and competences relating to the organization's effectiveness. The procedure of appointing an external audit firm is quite important. The hiring of external auditors could threaten the company's confidentiality. External auditors increase the company's costs. External auditors who are dishonest can damage a company's reputation. External auditors have the power to expose private information. Internal auditors should be made available and trained by the organization.

6. CONCLUSION

In conclusion, internal audit contribution is a significant determinant for the selection or retention of external audit services. This is consistent with the findings of previous research that internal processes are important for the sustainability of the firm (Khan, 2015a, 2015b). Hence, the study has significantly improved the understanding of the role of internal audits in external auditing acquisition. Providing further insight into the topic improves the perceptions that are related to the auditing process. More specifically, the variables like advising and policy check related to the selection or retention of external audit services seem to have a greater influence on the whole process. In general, the research suggests that be it a direct involvement or indirect involvement internal audit department's role is not limited to the accounts department only, but rather

when it comes, to auditing the task is spread over the administrative, financial as well as operational scope of the company. The internal audit function is playing an important role in evaluating and testing the social activities of the company and no more provides an assurance and/or consulting service on financial activities only (Hayek, 2015).

According to the data collected, there is substantial cooperation and coordination between internal and external auditing.

There are several contributions to the study. First, it supports arguments that auditing researchers have not been fully responsive to the issues associated with changes in internal audit, services that may be offered, and internal audit's growing function (Kikkas et al., 2018).

Second, while literature focused on the audit's relationship with external audit (Chartered Institute of Internal Auditors, 2020), little attention has been paid to the role of internal auditors in the acquisition of external audit services. Moreover, it is one of the few studies in the UAE that employs a quantitative approach to gather information from internal auditors about their role in the acquisition or retention of external audit services.

The findings also extend prior research to understand how different economies gain an understanding of the issue. For instance, given the analysis required priority data from the national banks, work is limited to considering the banks that responded to data making the scope and observation limited in number, as the sensitivity of the information (audit policy) and the requirement of receiving the data from the specific expert employees placed descending pressure on the sample size. Thus, possible response bias and small sample size possibly limit the generality of our result. Concerning the data collected, future researchers could also base their study on the different types of relationships that can exist between internal and external audits. As a result, it would make it possible to understand the level of interaction between the two and how they support each other and also substitute roles.

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