

# THE IMPORTANCE OF INTERNAL AUDIT IN INCREASING PERFORMANCE OF MICROFINANCE INSTITUTIONS: THE CASE OF THE DEVELOPING COUNTRY

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## Abstract

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The study aims to explore the role and importance of internal audit in increasing performance in microfinance institutions in Kosovo. The operation of microfinance institutions in Kosovo is a necessity to meet the demands of the people, households, and small businesses, who do not have access to financial banking services (Kupina, 2018). The presence of an internal audit body in the organization is a need and necessity for good governance and performance of the organization. This study was conducted in five microfinance institutions in Kosovo. The study is based on data collected from the field through a questionnaire (N = 80) conducted face to face with respondents, with both genders represented in microfinance institutions in Kosovo. The data collected from the field were systematized and analyzed in the SPSS program. Of the total number of respondents, 64% were male and 36% were female. Most of the respondents were economists (88%), lawyers (4%), IT (6%), and other professions (2%). The results of the study (96.3%) show that an internal audit is necessary for the organization. Also, from the findings of the study, we learned that (66.3%) internal audit positively affects good governance and performance of the organization.

**Keywords:** Audit, Internal Organizations, Performance, Kosovo

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## 1. INTRODUCTION

To enhance and protect organizational value, risk mitigation advice and analysis should be provided and long-term objectives should be established. For an internal audit function to be considered effective, all principles must be present and function effectively.

Microfinance is frequently considered both as a tool for fighting poverty in developing countries and as a tool for post-conflict reconciliation. Many countries have employed and created conditions for microfinance, especially after the 1990s, as a resource and additional capital for poverty reduction (Ahmeti, 2014).

The internal audit profession evolved steadily with the advancement of management science after World War II. It was conceptually similar in many ways to financial auditing by public accounting firms, quality assurance, and banking compliance activities. While some of the audit techniques contained in internal auditing are derived from management consulting and the public accounting professions, the theory of internal auditing was primarily conceived by Lawrence Sawyer (1911-2002), often referred to as the father of modern internal auditing. An internal audit is a critical summary of all aspects of the organization.

Recognizing the role and importance of internal audit, microfinance institutions in Kosovo, from the very beginning of their existence, have established internal audit departments operating under the International Standards for Professional Practice of Internal Auditing to increase the performance of the organization.

The important positive contribution that an internal audit can bring to in governance and operations of an organization depends on the effective implementation, functioning, and management of the internal audit function, which is possible only under the conditions of maintaining and strengthening its credibility (Zinca, 2016).

Internal audit has arisen as a need of managers to have a means of assessing the adequacy of work performed for the business, but also for the honesty of employees. The first signs of the development of internal audit appear in the early 2000s, which according to the law on internal audit is conceived as an independent activity, which provides objective assurance and advice to management designed to add value and improve the activities of subjects (Central Bank of the Republic of Kosovo [CBK], 2020).

Performance is the act of measuring the firm's efficiency and effectiveness and transforming its complex reality into organized symbols that can be related and transmitted under the same circumstances to manage its corporate and functional strategies (Koufopoulos, Zoumbos, Argyropoulou, & Motwani, 2008).

However, every organization needs to change/supplement new internal audit strategies, which will help increase the performance of the organization. In this case, this study aims to come up with new findings and recommendations that will help microfinance institutions, increase value and improve the performance of the organization.

The objectives of this study start from the description and analysis of multi-dimensional theories of the role of internal audit in increasing performance in microfinance institutions and the operation of internal audit under the International Standards for Professional Practice Internal Auditing. The objectives of the study are focused on the importance of an internal audit and the role and importance of an internal audit in the good governance of microfinance institutions in Kosovo. This study provides answers to how internal audit affects microfinance institutions.

The importance of the study lies in the fact of gaining and providing new knowledge to researchers and practitioners in the field of internal audit for general professionals in particular on the experiences and role of internal audit as a key pillar for governance and good performance of microfinance institutions.

The paper is structured as follows. Section 1 describes the main purpose of the study including the objectives of the study. Section 2 reviews the relevant literature. Section 3 provides methods used to collect the data. Section 4 presents the results of the study. Section 5 discusses the findings and Section 6 concludes the paper.

## 2. LITERATURE REVIEW

The origins of auditing go back to slightly longer times than accounting. Whenever the progress of civilization brought about the necessity of one man to believe to some extent in the wealth of another, the counseling of some kind of control over the loyalty of the former would become apparent (Mautz & Sharaf, 1961).

Internal audit through the activities performed adds value to properly evaluate the internal control system as well as the risk analysis related to the auditable activities and recommendations recorded in the reports prepared and submitted to achieve the objectives of the organization (Munteanu & Zaharia, 2014). Oussii and Taktak (2018) also show a positive effect of an internal audit on the quality of the internal control system.

The need for internal audit is making it an integral part of modern business. There is not any big business that exists without it. If they have not received it now, they will have to have it sooner or later, and if events unfold as they currently do, they will have to have it sooner (Hald, 1944).

One of the key trends recently identified internationally showed that we are now facing a very high interest in measuring and evaluating internal audit performance, which will lead to more attention in choosing those methods to reveal the real level of performance achieved by internal audit, both quantitatively and qualitatively (Boța-Avram, Popa, & Ștefănescu, 2011).

To improve risk management and internal control processes, internal auditors need to convince auditees of the quality of their work as well as persuade executives to implement their recommendations.

According to Roussy (2013), an internal audit has two roles: a protective and ancillary role. Internal audit, on the other hand, has the role of protecting senior managers from any pitfalls or obstacles and keeping secrets in addition to supporting organizational performance and providing guidance when new rules apply in the role of assistance. Thus, having a close relationship between the audit committee and internal audit improves governance.

The internal audit function is a major component of good corporate governance and its role has been emphasized as critical for promoting the achievement of corporate objectives (Salia, Addo, & Adoboe-Mensah, 2019).

Several theories can explain the need for an audit. Some of them are well-known and based on scientific research, while some others are based on perceptions (Ittonen, 2010; Hayes, Dassen, Schilder, & Wallage, 1999). An internal audit should be more future-oriented and focus on the new requirements of the company and the content of the fulfillment of its tasks (Lindner, 2003). Companies need to accelerate their change, while an internal audit is

challenged to integrate into this process and adapt to current environmental requirements (Tapestry Networks & Ernst&Young, 2013).

The operation of microfinance institutions in Kosovo is a necessity to meet the requirements of a part of the population, households, and small businesses, who do not have access to financial banking services (Kupina, 2018). Microfinance institutions in Kosovo started operating immediately after the war, in 1999, as financial assistance and micro-credit programs in support of small business initiatives in Kosovo. Their contribution has been important to start economic growth in the post-war period when the financial sector was almost non-existent (Association of Microfinance Institutions of Kosovo [AMIK], n.d.). Today, microfinance institutions continue to meet the needs of the Kosovo market by lending to small businesses and individual entrepreneurs, including farmers. The situation of microfinance institutions in Kosovo has improved and there is a stable financial sector. Microfinance institutions affect broader economic and legal aspects, and as such, they seem to have had a positive impact on the overall economic situation in Kosovo (Ahmeti, 2014).

According to Hegazy and Farghaly (2021), internal auditors possessed significant levels of knowledge and skills needed to fulfill their responsibilities, and most internal audit activities are still focused on financial audit and internal control activities.

To better meet the needs of Kosovo's small businesses and micro-business sector as well as to facilitate industry growth, in 2002, some microfinance institutions in Kosovo decided to establish a formal association called the Association of Microfinance Institutions of Kosovo (AMIK). Its mission is to advance the microfinance sector to support financial and social inclusion and economic development by providing a strong shared platform and excellent services. The main purpose of microfinance for a number of practitioners is to "improve the well-being of the poor" says Schreiner (2002, p. 591), noting that not everyone agrees on how to achieve this goal.

The fact that while there are opinions and divisions in terms of the role of microfinance, according to Duvedack et al. (2011), creates the separation of two theories on microfinance. The first created the literature which addresses the problems of poor people who do not have access to affordable financial services as a result of a lack of collateral. The second explores the ways and impact of microfinance on enterprises, households, and individuals.

### 3. RESEARCH METHODOLOGY

The study of each social phenomenon can be carried out from different perspectives, and to create a more comprehensive picture of what is happening, different methods can be used to gather different types of data (Matthews & Ross, 2010, p. 144). The research can be done in two ways, one way is to conduct a survey with the key employers and the other way is to collect data through questionnaires. This study is based on data collected from the field through a questionnaire (N = 80) conducted face to face with respondents, with both

genders represented in microfinance institutions in Kosovo. The age of the respondents varies from 21 to 50 years. Of the number of respondents, 64% were male and 36% were female. The majority of respondents were economists (88%), lawyers (4%), IT (6%), and others (2%).

The data were analyzed through the SPSS program, the descriptive analysis and correlations between variables are done, which have enabled us to understand the relationship between variables. The questionnaire was conducted in the field, visiting different headquarters and branches of microfinance institutions in Kosovo. The administration time of the questionnaire lasted 15–20 minutes. After conducting the questionnaires in the field, all of them were checked for accuracy separately and were systematized in the SPSS database.

Completion of the questionnaires was anonymous, but each participant had his/her number with which he/she submitted the questionnaire. The data is confidential, and participation was voluntary.

### 4. RESULTS

Based on the theories of audit in general and internal audit in particular, however, the principles of auditing, the latter has special importance in fulfilling the principles and regulations of the country and internationally. To understand to what extent microfinance institutions meet these legal requirements and audit principles in general, the study goes further to find out and understand whether internal audit takes place in these institutions. In the question posed to the respondents: "Does the internal audit take place in the organization where you work?", the results show that all (100%) of microfinance institutions in Kosovo conduct an internal audit. In one form or another, this result confirms the fact that microfinance institutions have a priori understood the role and importance of an internal audit for their organization. But, to understand in essence the acceptability, role, and importance of an internal audit, the study is further deepened by asking the question to the respondents such as: "Do you think that an internal audit is necessary for the organization where you work?". And, from the results obtained we understood that 96.3% of respondents stated that an internal audit is necessary for their organization. See Table 1 below.

**Table 1.** Do you think an internal audit is necessary for the organization where you work?

		<i>Frequency</i>	<i>Percent</i>
Valid	Yes	77	96.3
	I do not know	3	3.8
	Total	80	100.0

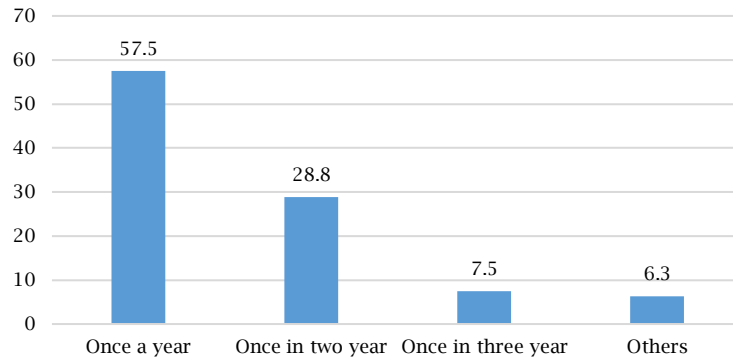
Of the total number of respondents, only 3.8% of respondents answered that they simply do not know whether or not an internal audit is needed in their organization, while others stated that it is necessary to conduct an internal audit in the institution where they work.

On the other hand, this study also focuses on the role and importance of good governance and performance enhancement in the organization that has an internal audit, and how well informed are

the employees in microfinance institutions. To understand and have more information on this issue, we ask the respondents the question: "For good governance and performance enhancement in the organization where you work, how often do you

think that an internal audit would be good to develop in your organization?". From the results (see Figure 1), we understand that 57.5% of respondents think that an internal audit should be performed at least once a year.

**Figure 1.** How often do you think an internal audit would be good to develop your organization?

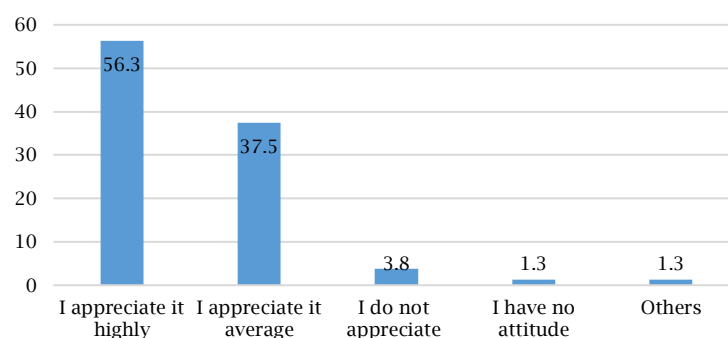


An internal audit is performed based on an internal audit plan of the organization which is created based on risks to determine the priorities of internal audit activities for good governance and increase the performance and goals of the institution, but for verification of these defined goals, the employees of microfinance institutions were asked in what time period they think that the internal audit should be carried out in their institution. More than half of the respondents (57.5%) state that an internal audit should be performed once a year, 28.8% of them state that an internal audit should be performed once in two years, 7.5% of the respondents think that they should have an audit in a longer period of time, i.e., once in three years, while 6.3% do not have any

position on what period of time an internal audit should be performed in their work organization.

An internal audit plays an important role in terms of evaluating the effectiveness of the functioning of internal control. To understand how much an internal audit affected the functioning of internal control in microfinance institutions in Kosovo, we asked the respondents the question: "How do you assess the effect of an internal audit on the functioning of internal control in the organization where you work?". From the results (see Figure 2), we understood that more than half of the respondents highly appreciate the effect of an internal audit on the functioning of internal control in the organization.

**Figure 2.** How do you assess the effect of an internal audit on the functioning of internal control in the organization where you work?



The results show that more than half of the respondents (56.3%) stated that they highly appreciate the effect of an internal audit on the functioning of internal control in the organization, 37.5% stated that they evaluate on average the effect of an internal audit on the functioning of internal control, 3.8% of respondents do not evaluate the effect of an internal audit, while 1.3% of respondents do not have an attitude.

Overall, the internal control system is designed to provide reasonable assurance regarding

the achievement of objectives relating to operations, reporting, and compliance. Therefore, an internal audit is effective in each of those categories of objectives when the board of directors and management take the assurance that the company's objectives are managed and the published financial statements are reliable (Koutoupis & Pappa, 2018).

The role of an internal audit as elaborated in the definition of an internal audit above includes the responsibility to evaluate and improve governance processes as part of providing security,

and to validate such a definition, 66.3% of respondents stated that an internal audit positively affects good governance of the institution and the organization where they work, 32.5% of them think that an internal audit has an impact on good governance on average, while only 1.3% of respondents think that internal audit has little impact on good governance of the institution where they work. See Table 2 below.

**Table 2.** Does an internal audit positively affect the good governance of the organization?

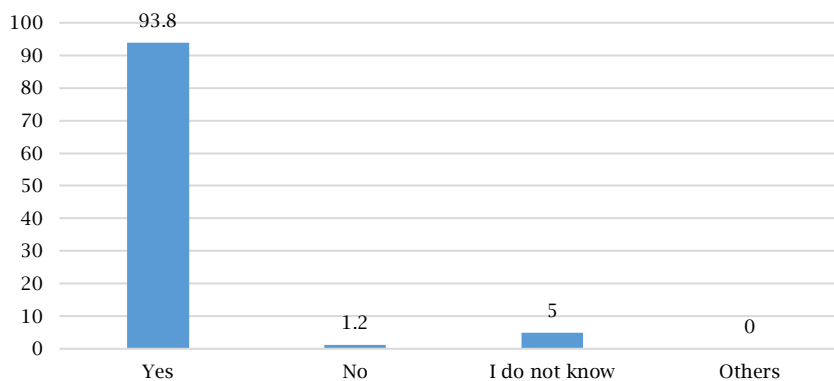
		Frequency	Percent
Valid	High	53	66.3
	Average	26	32.5
	Less	1	1.3
	Total	80	100.0

From the results obtained we clearly understand that an internal audit positively affects the good governance of the organization and as such is essential. Thus, the result of the study provides an answer to the research question raised: *“Does an internal audit positively affect the good governance of the organization?”*. An internal audit seems to make the enterprise staff more accountable and in particular the management to be more accountable in their actions in the organization and others related to the organization, making a positive

impact on the good governance of the organization. On the other hand, an internal audit assists management and staff in general through professional advice and constructive criticism aimed at the good governance of the enterprise. Therefore, from the results of the study and other studies, however, we clearly understand that an internal audit in the enterprise is not only a need and positively affects the good governance of the organization, but an internal audit is also a necessity for the enterprise to have good governance.

Implementation of internal audit recommendations in the enterprise is of particular importance for good governance and effectiveness of the enterprise. Actions taken by management to improve existing processes and controls are key indicators of effective governance. From various studies in the field of internal audit, there is a diversity of attitudes of those who have pro and contra attitudes regarding the fulfillment or implementation of recommendations arising from internal audit. The findings of our study show that internal audit recommendations are widely accepted and implemented in microfinance institutions in Kosovo. The results of the study (see Figure 3) show that the internal audit recommendations are accepted and implemented (93.8%) at a very high percentage.

**Figure 3.** Are the internal audit recommendations implemented?



From the findings of the study, we learn that microfinance institutions tend to implement the internal audit recommendations, only 1.2% state that the internal audit recommendations are not implemented in the institutions where they work, while 5% of respondents state that the recommendations are sometimes implemented or even have a different position on this issue. The cases when the internal audit recommendations are not implemented or are implemented very little are mainly the implementation of the recommendations that are mostly related to the problems that arise when the findings are related more to interpretations than to the concrete and fact-based conclusions. These situations can sometimes lead to dissatisfaction and recoveries which lead to non-compliance with the implementation of internal audit recommendations.

Viewed and analyzed both theoretically and practically, numerous researchers have shown that the implementation of internal audit recommendations has a positive impact on performance enhancement. To understand how positively the internal audit recommendations affect the performance of the organization, the study starts with the question for the respondents: *“Do the internal audit recommendations have a positive effect on increasing the performance of the organization?”*. From this, we understand that the results are positive and most respondents have a positive attitude in terms of increasing the performance of the organization by meeting the recommendations of an internal audit. See Table 3 below.

**Table 3.** Do internal audit recommendations have a positive effect on increasing the performance of the organization?

		<i>Frequency</i>	<i>Percent</i>
Valid	Yes	64	80.0
	No	1	1.3
	Some times	12	15.0
	Others	3	3.8
	Total	80	100.0

The results of the study make us understand that 80% of respondents have a positive attitude regarding the increase in performance from the fulfillment or implementation of internal audit recommendations. While, 15% of respondents think that fulfilling the recommendations sometimes has an impact on increasing performance, but not always. Negative attitude or disagree (1.3%) with the fact that the fulfillment of internal audit recommendations affects the increase in the organization's performance and 3.8% of other cases, therefore, have different attitudes. Therefore, as can be seen from the results of the study, it is clear that the fulfillment or implementation of internal audit recommendations by the management and staff of the organization has a positive impact on increasing the value and performance of the organization.

Monitoring is a follow-up process, during which internal auditors evaluate the appropriateness, effectiveness, and timeliness of actions taken by the organization's management to address each internal audit recommendation. Monitoring or monitoring the implementation of recommendations is considered to be of particular importance. To learn more about monitoring internal audit recommendations in microfinance institutions in Kosovo, we asked respondents the question: "Are the fulfillment or implementation of internal audit recommendations monitored in the organization where you work?". Of the total number of respondents interviewed, 81.3% admit that the fulfillment of recommendations is monitored in their organization, and also admit that recommendations are monitored and reported on a regular basis. See Table 4 below.

**Table 4.** Are the fulfillment or implementation of internal audit recommendations monitored?

		<i>Frequency</i>	<i>Percent</i>
Valid	Yes	65	81.3
	No	2	2.5
	Some times	7	8.8
	Others	6	7.5
	Total	80	100.0

However, the results also show that 2.5% of respondents deny that monitoring or follow-up of the implementation of internal audit recommendations has ever been done in their organization, 8.8% of respondents have no knowledge regarding this issue and 7.5% do not have a position on about monitoring or following-up on the implementation of internal audit recommendations in their organization.

## 5. DISCUSSION

The main focus of this study is to highlight the role and importance of an internal audit in increasing the value and performance of microfinance institutions

and to come up with some recommendations that would increase their performance.

"Audit is an added value for the bank (65% always answered and 24% usually) and helps improve processes (70% always answered and 23% usually) and improves control within the bank (64% always answered and 28% usually)" (Kristo, 2014, p. 87).

Based on the findings of our study, we found that 96.3% of respondents stated that an internal audit is necessary for their organization. The study shows that 57.5% of respondents think that internal audit should be performed at least once a year. While more than half of the interviewed respondents (56.3%) highly evaluate the effect of an internal audit on the functioning of internal control in the organization, 37.5% stated that they evaluate on average the effect of an internal audit on the functioning of internal control, 3.8% of respondents do not evaluate the effectiveness of an internal audit, while 2.4% of respondents do not have an attitude.

The results of our study lead us to understand that 66.3% of respondents interviewed stated that an internal audit positively affects the good governance of the organization where they work, and 32.5% of them think that an internal audit has an impact on the good governance on average, while only 1.2% of respondents think that an internal audit has little effect on the good governance of the institution where they work.

The results of the study show that internal audit recommendations are accepted and implemented (93.8%) to a large extent. Therefore, from the findings of the study, we learn that microfinance institutions tend to implement internal audit recommendations, only 1.2% state that the internal audit recommendations are not implemented in the institution where they work, while 5% of respondents state that the recommendations are sometimes implemented or even have a different position on this issue.

Implementation of internal audit recommendations for senior management is considered an indicator of internal audit performance (Dumirescu, Bobi, & Costuleanu, 2014; Soh & Martinov-Bennie, 2011; Ziegenfuss, 2000).

Managers and officials must decide whether and how to implement the internal audit recommendations. Therefore, in the end, the effect that internal auditors have on the achievement of corporate objectives is influenced by the extent to which managers utilize the work of internal auditors. In such a perspective, the relationship between internal auditors and managers (auditees) becomes a critical issue (Arena & Azzone, 2009).

The findings of the study make it clear that 80% of respondents have a positive attitude in terms of increasing performance by fulfilling or implementing internal audit recommendations, while 15% of respondents think that fulfilling the recommendations sometimes has an impact on increasing performance, but not always. Negative attitude or disagree (1.3%) with the fact that the fulfillment of internal audit recommendations affects the increase in performance of the organization and 3.8% of other cases, therefore, have different attitudes.

One of the main components which tells us about the implementation of the recommendations and the increase in performance is the monitoring or follow-up of the implementation of the recommendations which is considered to be of special importance.

## 6. CONCLUSION

From the findings of this study, we conclude that microfinance institutions in Kosovo have understood the role and importance of an internal audit and see it as a need and necessity for good governance and performance of the organization.

Determining performance indicators is of great importance to determine the extent to which the audit function achieves its objectives, following quality practices and standards (Zinca, 2016).

From the above, we conclude that for the performance and good governance of the organization, an internal audit should be performed at least once a year and should be performed based on an internal audit plan of the organization which is drafted on the basis to determine the priorities of internal audit activities to better govern and increase the performance and goals of the institution, but to verify these goals, employees of microfinance institutions were asked in what time period they think that internal audit should be performed in their institution.

Also, based on the findings of the study we can conclude that an internal audit has a positive effect on the functioning of internal control of the organization.

An internal audit, as elaborated in the definition of an internal audit and the findings of the study, involves the responsibility to evaluate and improve governance processes as part of providing assurance and validate such a definition. From this, we can conclude that an internal audit positively affects the good governance and performance of the organization. Therefore, from the results obtained we can conclude that an internal audit positively affects the good governance of the organization and as such is necessary. An internal audit makes the staff of

the organization more accountable and in particular the management to be more accountable in their actions in the organization and others, making a positive impact on the good governance and performance of the organization. An internal audit assists management and staff in general through professional advice and criticism, which have a positive impact on the good governance and performance of the organization.

Based on the findings of our study we conclude that internal audit recommendations are widely accepted and implemented in microfinance institutions in Kosovo. Thus, internal audit recommendations are accepted and implemented (93.8%) on a large scale.

According to the CBK (2021), during the first quarter of 2021, the sector recorded a quarterly increase in lending, positive financial performance as well as a low level of non-performing loans. The microfinance sector closed the first quarter of 2021 with a profit. The financial performance of the sector was also reflected in the two profitability indicators, return on average assets (RAA) and return on average capital (RAC), which marked a significant increase in the first quarter of 2021.

Based on the results of our study we conclude that the implementation and fulfillment of internal audit recommendations have a positive impact on increasing the performance and good governance of the organization.

Also, monitoring or following up on the implementation of the recommendations from internal auditors, but also the organization, is of particular importance and has a positive impact on the performance and good governance of the organization and is present in microfinance institutions in Kosovo.

In conclusion, an internal audit is an independent activity to provide objective assurance and advisory activity, designed to add value and improve the operations of the organization. An internal audit assists the organization in meeting objectives, fostering a systematic and disciplined approach to assessing and improving effectiveness in risk management, controls, and governance processes.

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