

EXTERNAL AUDITORS' RELIANCE ON THE  
INTERNAL AUDIT FUNCTION: THE LIBYAN  
PERSPECTIVE

BY

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## **ABSTRACT**

Auditing in Libya is considerably unregulated. There is only minimal regulation on auditing and auditors; there are no auditing standards and there is no requirement to comply with specific auditing standards or guidelines. Therefore, some companies and particularly the bigger audit firms in Libya would refer to the International Standards on Auditing (ISA) and the Statements on Auditing Standards (SAS). Both ISA and SAS allow the external auditors to rely on the efforts of their internal counterparts, subject to considering three key elements of internal audit (IA) quality, which are: competence, objectivity and work performed. This reliance may be more challenging in Libya due to the unstandardized quality of the internal audit function (IAF). Therefore, the objectives of this study are to examine the perception of the external auditors regarding the competence, objectivity and the work performed by the IAF of the Libyan companies; as well as to determine whether the external auditors would rely on the output produced by this function, based on their perception of the three IA quality elements. This study applied the attribution theory to develop the hypotheses to be tested. Out of the 110 self-administered questionnaires, 94 were useable. The results of this study revealed that, based on the perception of the Libyan external auditors, from the three elements of IA quality, work performed was deemed most important, followed by competence, then objectivity. Moreover, in terms of the influence of these three factors on the reliance decision, it was found that objectivity and competence were found to have a significant positive association with reliance by the external auditors. These findings should be useful to Libyan regulators, as well as the companies to consider reducing audit fees by improving on these three IA quality elements. Furthermore, this study extends the literature, specifically in the context of Libya.

## خلاصة البحث

التدقيق في ليبيا غير منظم إلى حد كبير، هناك حد أدنى من اللوائح الخاصة بالتدقيق والمدققين، ولا توجد معايير تدقيق ولا يوجد شرط للامتثال لمعايير أو إرشادات تدقيق محددة، لذلك؛ فإن بعض الشركات وخاصة شركات التدقيق الكبرى في ليبيا قد تشير إلى المعايير الدولية للتدقيق (ISA) بيانات معايير التدقيق (SAS)، ويسمح كل من ISA و SAS للمدققين الخارجيين بالاعتماد على جهود نظرائهم الداخليين، مع مراعاة ثلاثة عناصر رئيسية لجودة التدقيق الداخلي (IA)، وهي: الكفاءة والموضوعية والعمل المنجز، قد يكون هذا الاعتماد أكثر صعوبة في ليبيا بسبب الجودة غير المعيارية لوظيفة التدقيق الداخلي (IAF)، وبالتالي؛ فإن أهداف هذه الدراسة هي فحص تصور المدققين الخارجيين فيما يتعلق بالكفاءة والموضوعية والعمل الذي يؤديه IAF للشركات الليبية، وكذلك لتحديد ما إذا كان المدققون الخارجيون سيعتمدون على المخرجات التي تنتجها هذه الوظيفة، بناءً على تصورهم لعناصر جودة التدقيق الداخلي الثلاثة، طبقت هذه الدراسة نظرية الإسناد لتطوير الفرضيات المراد اختبارها، من أصل 110 استبياناً تم إجراؤها ذاتياً، كان 94 استبياناً صالحاً للاستخدام، وكشفت نتائج هذه الدراسة، بناءً على تصور المدققين الخارجيين الليبيين، من العناصر الثلاثة لجودة التدقيق الداخلي، أن العمل المنجز كان الأهم، يليه الكفاءة، ثم الموضوعية، علاوة على ذلك، وفيما يتعلق بتأثير هذه العوامل الثلاثة على قرار الاعتماد، فقد وجد أن الموضوعية والكفاءة لهما علاقة إيجابية كبيرة باعتماد المدققين الخارجيين، ويجب أن تكون هذه النتائج مفيدة للجهات التنظيمية الليبية، وكذلك الشركات للنظر في تخفيض رسوم التدقيق من خلال تحسين عناصر جودة التدقيق الداخلي الثلاثة، وعلاوة على ذلك، توسع هذه الدراسة نطاق الأدبيات، وخاصة في سياق ليبيا.

## APPROVAL PAGE

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## DECLARATION

I hereby declare that this dissertation is the result of my investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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*This thesis is dedicated to my lovely parents for laying the foundation of what I turned  
out to be in life:*

***Ramadhan Ahmed Bin Husayn***

***Khadija Masoud Shiar***

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## **LIST OF ABBREVIATIONS**

AICPA	American Institute of Certified Public Accountants
CG	Corporate Governance
GAIN	Global Audit Information Network
IFAC	International Federation of Accountant
IA	Internal Audit
IAF	Internal Audit Function
IIA	Institute of Internal Audit
ISA	International Standards on Auditing
LAAA	Libyan Accountant and Auditors Association
SAS	Statements on Auditing Standards

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

At the beginning of the 21st century, there was an urgent emphasis for organizations to strengthen their corporate governance (CG) system. These necessities to improve CG mechanisms were partly due to Enron and World.com debacles. One of the key components in a company's CG system is the internal audit function (IAF). This function plays an essential role in evaluating the effectiveness of the internal control mechanism and strengthening the internal control (Cohen, Krishnamoorthy & Wright, 2002). Due to the need for internal auditors to play a bigger part in a company's CG system, the Institute of Internal Auditors (IIA, 2004) has revised the definition to what constitutes an IAF as follows:

*“an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”.*

This definition signifies the importance of IAF, where its focus has expanded from an assurance service regarding past events to include future performance, which assists organizations to operate more effectively and efficiently (Nagy & Cenker, 2002). Meanwhile, Gramling, Maletta, Schneider, and Church, (2004) provides a comprehensive literature of past studies on the evaluation and growth of the role of IAF, which can be used as a reference by future research, in order to contribute to a better

quality of corporate governance. The study concludes that there is a need for increased understanding about how the IAF interacts with other CG mechanisms such as the board of directors, audit committees as well as external auditors.

The contribution that IAF makes towards assisting the external audit in completing the audit of financial statements has gained considerable attention over time (Abdel-Khalik, Snowball & Wragge, 1983; Glover, Prawitt & Wood, 2008; Krishnamoorthy, 2002; Mubako & Muzorewa, 2019; Quick & Henrizi, 2019; Saidin, 2014; Schneider, 2010). Although the roles of IAF and external audit are distinct, an opportunity seems to be available for collaboration between these two kinds of auditors that may yield higher audit quality and lead to economic advantages (Felix, Gramling & Maletta, 2001; Pizzini, Lin & Ziegenfuss, 2015; Suwaidan & Qasim, 2010). Indeed, the auditing standards recognized the contribution that the IAF could render to the external audit process. For example, the International Standards on Auditing (ISA) 610 and Statements on Auditing Standards (SAS) 65 suggest that IAF should encompass specific factors that could enhance the quality of IAF namely (1) competence, (2) objectivity, and (3) work performed. Hence, these factors are considered and reviewed by the external auditors before they rely on the IAF.

Numerous prior studies have investigated the reliance of external auditors on the IAF. On one hand, most of these past studies were conducted in developed countries, especially in the United State of America (US) (Glover et al., 2008; Brody, 2012; Malaescu & Sutton, 2015; Schneider, 2010). Other studies were carried out in Canada (Desai, Roberts & Srivastava, 2010; Messier, et al., 2011), and Australia (Munro & Stewart, 2011). On the other hand, literature in developing countries includes studies in Jordan (Al-Sukker, et al., 2018; Suwaidan, & Qasim, 2010), studies in Malaysia (Haron, Chambers, Ramsi & Ismail, 2004; Mohamed, et al., 2012) a study in Saudi Arabia (Al-

Twaijry, Brierley & Gwilliam, 2004) and a study in Croatia (Čular, Slapničar & Vuko, 2020). The purpose of this study is to replicate these studies by examining the reliance decision of external auditors on the IAF in a developing country, which in this case is Libya. Prior to stating the research objectives, the next section explains the problem statement, specifically in relation to the context of this study.

## **1.2 STATEMENT OF THE PROBLEM**

Generally, as recommended by the auditing standards (ISA and SAS), if the internal auditors are objective in their decisions and conclusion, and if they perform their tasks completely and effectively, then the external auditors could rely on the IAF. Hence, as these factors are mentioned above, a number of past studies have investigated the reliance decision of external auditors on the IAF in both developed and developing countries. However, Zakari (2013) states that the practice of IAF is different between developed and developing countries. This difference is a result of a poorly developed corporate market, audit sector, regulatory involvement, and weak legal system in developing countries. Al-Twaijry, Brierley & Gwilliam (2004) have also stated that in developing countries, the internal auditors may not fully appreciate the processes and requirements of a comprehensive internal audit due to lack of guidelines, regulation, and resources. Therefore, since the regulatory environment of each country differs, there would be a need for a study in Libya, even though there are prior studies in other countries.

Furthermore, there are considerable challenges in the accounting profession in Libya. Several authors (Ahmed & Gao, 2004; Shareia, 2010; Faraj & Akbar, 2010; Abuazza, Mihert, James & Best, 2015) have identified that the audit profession in Libya, both external and internal, have limitations where the Libyan Accountant and Auditors

Association (LAAA) has not met its main objective, which is to issue a theoretical base for accounting and auditing standards (Ahmad & Gao, 2004). Breger, Edmonds, and Ortegren (2020) provided evidence due to the lack of standards in relation to audit, the auditing practices in the Libyan companies are based on the preference of the auditors. This preference for audit practices and specific auditing standards were developed based on the auditors' educational background and audit training (Faraj & Akbar, 2010). For example, a study conducted by Eghliaow (2013) found that audit firms in Libya employ different auditing standards, processes, and methods for producing audited financial reports, whereas Shareia (2010) found that there is a huge gap in the Libyan auditor reports due to the unstandardized educational and professional background of the auditors. As Al-Kilani (2000) argued, it could be due to the fact that some organizations had established their own guidelines on IAF because of the limited professional auditing standards issued by the LAAA. Breger et al. (2020) provided evidence that external auditors may rely on the work of internal auditors in accordance to the standards issued by the IIA if the latter meets a specific level of audit quality. However, as explained above, the audit practices in Libya are varied, inconsistent and lack proper regulation. This could provide a considerable challenge for external auditors to depend on the IAF of Libyan companies.

Basically, the auditing standards, ISA or SAS have proposed that a synergy is created when competent and objective internal auditors cooperate with competent and independent external auditors. However, based on the scenario where there is a lack of audit regulation, specifically in relation to IAF, as explained above, the external auditors may have a wide range of perception on the competency of the internal auditors, their objectivity, as well as the quality of work performed by the IAF. However, the perception of external auditors as well as their potential reliance on the IAF is unknown

because of the limited empirical studies available in Libya in this particular area. This gap in the literature warrants such a study as stated in the research objectives below.

### **1.3 RESEARCH OBJECTIVES**

This study aims to investigate a reliance relationship that could exist on the part of the external auditors upon the work of the internal auditors in Libyan companies. In particular, the following sub-research objectives are stated:

- 1- To explore the perception of the external auditors on the competence, objectivity, and work performed by the IAF in Libyan companies.
- 2- To examine the implication of the perception on competence, objectivity, and work performed by IAF on the reliance of the Libyan external auditors.

### **1.4 RESEARCH QUESTIONS**

In line with the research objectives above, two research questions are to be answered by this study:

- RQ1- What is the perception of the external auditors on the competence, objectivity, and work performed by the IAF in Libyan companies?
- RQ2- Does the perception of competence, objectivity, and work performed by the IAF have any implications on the decision by external auditors to rely on the former's work?

### **1.5 MOTIVATION AND SIGNIFICANCE OF THE STUDY**

Although the motivation of the current study has been applied earlier, this section highlights motivation for conducting the study, along with the significance of the study. Additionally, the study is motivated by the fact that there is evidence that the audit

profession in Libya is still lacking and has room for improvement. As earlier stated, most of the previous studies were conducted in developed countries where the audit profession is highly sought after as compared to the audit work opportunity in developing countries, particularly in Libya. Hence, little is known about reliance decisions in developing countries, especially in the case of Libya. Based on the updated search of contemporary literature on Libya, there is still a small number of studies that specifically investigates the reliance on IAF by external auditors of Libyan companies. Therefore, the study is motivated by the lack of studies in this area, especially in the Libyan context.

This study is expected to assist in developing the body of knowledge, particularly in relation to reliance decision of external auditors on the work of the IAF in Libya. The audit practice in Libya is considered self-regulated where an audit firm would set up its own policies. Hence, the study would provide an empirical insight on the influence of IAF on the reliance decision among the external auditors in Libya, whilst extending the literature, and as a reference for future research.

Moreover, the findings of the current study are expected to provide valuable insights to the policymaker in Libya (i.e., Audit-bureau of Libya) as the current status of audit practice in Libya is still unregulated for both external and internal auditors. Therefore, by examining the perception of external auditors regarding the three elements of IAF quality (competence, objectivity, and work performance), as well as their reliance decision on the IAF, it can provide a clear understanding to the regulators, stakeholders and potential users of the IAF, i.e., the external auditors on the quality of the IAF. The views of the external auditors are important as they are generally considered to be independent experts in the same field, hence they are qualified to give their opinion on audit matters, in this case the IAF. Regulators may be able to improve

guidelines if the external auditors perceive certain aspects of IAF to be lacking; that is either in terms of the objectivity of the internal auditors, their training or in terms of the internal audit work performed in Libyan companies.

Furthermore, the companies in Libya could also benefit from the findings of this study. This is because if the study found that the external auditors rely on the work produced by the IAF if certain aspects of the function were strengthened, then the companies could consider improving these affected areas. Subsequently, if the external auditors could rely on the work performed by the IAF, the audit reports to be produced would be in order and financial statements could be issued on time and at reduced audit fees.

## **1.6 ORGANISATION OF THE STUDY**

The thesis comprises of six chapters. The first chapter, Chapter One, introduced the dissertation with the background of the study, problem statement, research objectives as well as research questions, in addition to highlighting the motivations and significance of the study. Next in Chapter Two, there is a literature review of past studies pertaining to decision made by external auditors in relation to the work done by the IAF. The review comes after the description of the audit environment in Libya. The chapter ends with the identification of the gap in the literature. Chapter Three explains the theoretical framework employed in this dissertation. This particular chapter describes the relevance of Attribution Theory on the audit reliance decision for developing the hypotheses, meanwhile; Chapter Four explains the design of study, questionnaire development, and measurement. Next, Chapter Five provides an analysis and discussion of the result on the tested data. Finally, Chapter Six is the conclusion chapter, whereby it serves as the final chapter of the study. The chapter contains a

summary of findings, discussion, and implications of the study, as well as the limitations of the study. The chapter also presents several recommendations for future research.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

This chapter generally provides an overview of the literature that examines the external auditors' reliance on the work performed by the internal auditors. The literature review chapter also explores the existing professional standards related to the possibility of reliance by external auditors on existing IAF in companies. This chapter is presented as follows: Section 2.2 highlights the existing auditing standards, in particular the ISA and SAS, in regard to external auditors referring to the work of their internal counterparts. This is followed by auditing in Libya. Section 2.3 briefly reviews the literature on the internal audit function. Section 2.4 presents the importance of audit reliance followed by an overview of audit reliance literature in Section 2.5. Then Section 2.6 specifically focuses on the literature that examined the quality of the IAF and their implications on the reliance decision. This literature is divided into developed and developing countries. The final section provides the gap in the literature and summary of the chapter.

#### **2.2 AUDITING REGULATION AND AUDITING IN LIBYA**

This section of the literature review discusses the related auditing standards from the International Standards on Auditing (ISA) by The International Federation of Accountants (IFAC), and the Statements on Auditing Standards (SAS) by The American Institute of Certified Public Accountants (AICPA). In addition, this section explains the audit environment in Libya.

### **2.2.1 Review of Relevant Auditing Standards**

This section discusses the auditing standards that specify the conditions which allow external auditors to rely on the work produced by the IAF. For example, the ISA 610 and SAS 65 suggest that IAF should encompass specific factors that indicate the quality of IAF as shown in Table 2.1.

The SAS No. 65 was issued by AICPA in 1991, “The Auditors’ Consideration of Internal Audit Function in an Audit of Financial Statement”, which has superseded SAS No. 9, “The Effect of Internal Audit Function on the Scope of Independent Auditor’s Examination”. SAS No. 65 provides guidance that the IAF could affect the nature, scope, and extent of financial statements audited by external auditors. Therefore, prior to relying on the IAF, the external auditor has to evaluate the objectivity of the internal auditors and the effectiveness of their work.

The IFAC issued the ISA No. 610, “Using the Work of Internal Auditors” in 2009<sup>1</sup>. ISA 610 prescribed that after the external auditors evaluate the processes, procedures, and mechanisms undertaken by the internal auditors, as well as are satisfied that these are adequate for the former’s audit purposes, they can utilize some of the work prepared by the latter. Furthermore, the internal auditors are even allowed to assist in the external audit under the direct supervision and review of their external counterparts. Both SAS 65 and ISA 610 agree on certain key factors that would enable the external auditors to rely on the IAF. These key factors are competence, objectivity, and work performance and communication between the two types of auditors. Table 2.1 below summarizes the requirements of SAS 65 and ISA 610 on the qualities and

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<sup>1</sup> ISA No. 610 was revised in 2013.

procedures necessary to attain and develop competence, objectivity, and work performance of internal auditors.

Table 2.1: Summary of the Audit Standards on the Elements of Audit Reliance

<b>Standard Elements</b>	<b>SAS 65</b>	<b>ISA 610</b>
<b>Competence</b>	<ul style="list-style-type: none"> <li>Professional qualification, knowledge, and work experience.</li> <li>Prescriptive audit policies, programs, and procedures; Quality reports and recommendations.</li> <li>Policies on recruitment; Reviews and performance evaluation procedures.</li> </ul>	<ul style="list-style-type: none"> <li>Knowledge, technical training.</li> <li>Adequate resources; Procedures on preparing reports.</li> <li>Policies and procedures for recruitment.</li> </ul>
<b>Objectivity</b>	<ul style="list-style-type: none"> <li>Report to an appropriate and qualified to ensure sufficient coverage and supervisors' scope of audit.</li> <li>Audit committee/Board of directors oversee hiring decisions.</li> <li>Prevention policies on employing relatives for audit sensitive positions.</li> </ul>	<ul style="list-style-type: none"> <li>Member of the relevant professional body and comply with the standards of objectivity.</li> <li>Ability to be free from bias/conflict of interests.</li> <li>Free to report audit findings to external auditors.</li> </ul>
<b>Work performance</b>	<ul style="list-style-type: none"> <li>The appropriate scope of work.</li> <li>Adequate documentation of supervision and work performed.</li> <li>Quality reports as an output from work performed.</li> </ul>	<ul style="list-style-type: none"> <li>Documentation on audit procedures, guidelines, areas of risk, work performed, and reports.</li> <li>Evidence of adequate quality control policies and procedures.</li> </ul>
<b>Communication</b>		<ul style="list-style-type: none"> <li>Procedures/plans to cooperate with external auditors in a constructive and complementary manner.</li> </ul>

### 2.2.2 Auditing in Libya

A brief overview of the status of the accounting profession in Libya, which includes auditing, is described in this section. Libya is a developing country located in North-Africa. Libya obtained its independence from Italy in 1952. Previously, in 1969 Libya