

## Whistleblowing Practice in the Public Sector and Internal Audit Effectiveness

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**Abstract.** The practice of whistleblowing has received increased worldwide attention since the collapse of Enron and Worldcom. In Malaysia, the Whistleblowing Protection Act (WPA) was introduced in 2010 by the government as one of the internal control mechanisms to mitigate issues of corruption, lack of integrity, malpractices and fraud, among others, in both the public and private sectors. Despite the introduction of this Act, the implementation of whistleblowing practice in the public sector is still at an early stage. This paper reviews the literature on internal audit in the public sector and examines the factors associated with audit effectiveness in mitigating the incidents of fraud. The reviews result in a proposal to suggest that the effectiveness of public sector internal audit is affected by the proficiency of auditors, the independence of internal auditors and the quality of internal audit. This study also proposes that the whistleblowing practice moderates the relationships between the factors and the internal audit effectiveness. This conceptual paper employs the institutional theory and the theory of justice in predicting the expected relationships. This paper contributes to the internal audit field by providing an integrated conceptual framework regarding internal audit effectiveness and the role of whistleblowing practice. The outcome of the proposed research is expected to provide new insights to regulators, policy makers, auditors and the public on the role of whistleblowing in increasing internal audit effectiveness, particularly in the public sector.

### Introduction

The increasing trend of corruption, lack of integrity and transparency, fraudulent cases, malpractices and financial irregularities are not limited to the private sector. Concerns of poor quality of service delivery and financial malpractice are also on the rise in the public sector as well. As a result, the Malaysian government has introduced the Whistleblower Protection Act 2010 (WPA 2010) which came into force in 2010 as one of the initiatives under the National Key Results Area (NKRA) and the Government Transformation Plan (GTP) to fight corruption [37]. However, the issue of frauds is still on-going which makes the effectiveness of internal audit in the public sector more critical than before [7]. In recent years, several measures have also been initiated by the government to strengthen the role of internal auditors together with the implementation of WPA 2010. As a result, internal audit now includes promoting the whistleblowing best practice even though the ultimate operational responsibility for whistleblowing procedures still lies with executive management, reporting to the board [19].

Despite the increasing importance of internal audit especially to combat fraudulent acts and mismanagement, research which addresses the issue of internal audit effectiveness is still limited [14]. Among others, recent studies suggests a need for a more inclusive study of the effectiveness of internal audit [10] and further examination of factors which contribute to internal audit effectiveness [13]. In line with these suggestions, the present study examines the effect of the whistleblowing practice towards the Effectiveness of Public Internal Audit. This paper reviews and discusses factors which contribute to internal audit effectiveness and proposes whistleblowing practice as a new determinant. The whistleblowing practice is expected to moderate the direct relationships between the factors and audit effectiveness. The structure of this paper is as follows: the following section discusses the internal audit in the public sector. Section three presents the literature review of factors which influence the internal audit effectiveness. Finally, the last section provides the conclusions and recommendations for future research.

### Literature Review

**Public Sector Internal Audit in Malaysia.** The establishment of Internal Audit departments in the Malaysian public sector was imperative in recognising the importance and essence of internal auditing. Initially, the authority for the establishment was made possible through Treasury Circular Ref. 2 of 1979 [32] under the title of the Implementation of Internal Auditing in Federal Government Agencies. Progressively, the extension of the scope has been recognized in later

years where the scope covered both, financial and management audits. The scope of work of the Internal Audit Unit in the public sector was intended to cover all Divisions/Branches in the Ministries/Departments and Federal Statutory Bodies (which does not have Internal Audit Unit) under the supervision of the Ministries in accordance with the regulatory requirements of General Circular No. 3 of 1998 [7].

In 2004, the initial government circular on the Implementation of Internal Auditing in Federal Ministries and Departments and State Governments was replaced by Treasury Circular Ref. 9 of 2004 replaced [33]. This revised circular extended the requirement to establish the internal audit unit to all Ministries, Departments and State Government level, and to agencies and departments in the State Governments. The new circular also highlights the roles and responsibilities of the Internal Audit department, the secretary-general and the Treasury, and provides direction on the implementation of Internal Audit. The execution of auditing process has been designed to suit the expansion and changes in the internal Audit role especially in giving advice and adding value to the organization in line with (1PP - 1 Pekeliling Perbendaharaan) or 1 Treasury Circular. Apart of the 1PP, two main sections were outlined to describe the duties and establishment of the Internal Audit function. These are PS 3.1/2013 and PS 3.2/2013. [34] outlines the roles and responsibilities of the Internal Audit unit, Ministry Secretary or Head of Federal Department or State Secretary and the Treasury of Malaysia. This circular also details the commands of internal audit duties. The main objective of the circular is to assist the public sector in evaluating and determining the effectiveness of all internal control processes and governance in order to achieve its established goal.

**Effectiveness of the public sector internal audit.** An effective internal audit refers the ability of the internal auditors to achieve established objectives within the organization being audited [9]. The value adding role of the internal audit presumes that the audit is effective. An effective internal audit system assists organizations to achieve the desired performance and profitability, prevents loss of revenues, ensures reliable financial reporting and compliance with laws and regulations, reduces damages to its reputation and other unfavourable consequences [36]. Nevertheless, the literature implies that the internal audit effectiveness tends to be influenced by other contextual dynamics within which the internal audit is practiced.

It is important for various stakeholders and policy makers to understand the critical role of the internal audit in striving for financial viability and financial health of the government. At present, there is a limited number of academic studies covering the topic the internal audit effectiveness [14]. Furthermore, most of the studies touch on the private sector and very few cover the public sector. For example, [13] investigate the factors that influence the effectiveness of internal audit function in Jamaican commercial banks. According to the findings, the quality of audit investigation, organisational independence, professional proficiencies and management support have significant impact on the internal audit effectiveness in the commercial banks sector.

Other determinants of internal audit effectiveness which have been studied include independence; competence; scope of work; and work performance as indicators of internal audit effectiveness which were based on compliance with the International Standards for Professional Practice of Internal Auditing (ISPPA) [31]. Similarly, [25] use internal auditor objectivity, internal auditor proficiency, quality of internal audit planning and execution, and quality of internal audit reporting and follow-up as the indicators of internal audit effectiveness.

Studies which have been conducted on internal audit effectiveness in developing economies include Jamaica [13]; Libya [31] Ethiopia [11]; [24], Indonesia [15], Malaysia [1]; [7]; [3];[26], Nigeria [9] Israel [14], Saudi Arabia [63], Ghana [8], Thailand [35] and Greek [18]). Overall, these studies suggest that that there is a gap in their findings on the issue of internal audit effectiveness. Furthermore, these studies also examine mixed factors and utilize different criteria and theories when discussing the internal audit effectiveness in the two different sectors (i.e., public and private).

According to [13] and [9] future research could be conducted to study the effectiveness of internal audit in both public and private. In addition, further study should also concentrate on the examination of other factors that contribute to the internal audit effectiveness which were not yet examined [13]. Following that suggestion, the present article focuses on three factors, namely, Internal Audit Quality (IAQ), Independence of Internal Auditors (IoA) and Proficiency of Internal Auditors (PoA) in affecting the internal audit effectiveness. The decision to study these factors is based on the International Standards for Professional Practice of Internal Auditing (ISPPA). In addition, this study introduces the Practices of Whistleblowing (PoW) as a moderating variable in assessing the effectiveness of the public sector internal audit in Malaysia.

**Internal audit quality.** Internal Audit Quality (IAQ) is demonstrated by the capability of the audit to provide useful audit findings and recommendations. It is one of the most prominent factors on which audit effectiveness is anchored [24]. Based on the study in the public sector of Ethiopia, the internal audit effectiveness is affected by the IAQ, along with the support of management, the organizational environment and the characteristics of the organization. Internal auditors are highly accountable to ensure that they would be able to arrive at useful findings. Therefore, audit quality is arguably a function of staff expertise, reasonableness of the scope of service, and effective planning, execution and communication

of internal audits. [1] report that internal audit competence, objectivity and quality of work performed are classified as internal audit quality since these factors are the important criteria used by external auditors in evaluating the IAQ.

**Proficiency of internal auditors.** Proficiency of Auditors (PoA) was examined by [17] and conclude that the internal audit offices constantly face the problem of low technical staff proficiency and high staff turnover, which would limit their capacity to provide effective service to the management. Proficiency relates to the ability of an individual and setting of the department to perform a job or task properly based on the educational level, professional experience, budget of the department, training and hiring policies, capacity of the department, internal audit manual and the effort of the staffs for continuing professional development that improves the effectiveness of internal audit [11]

**Independence of internal auditors.** The independence of internal auditors is crucial because the auditors have access to any document, works and procedures without favour and fear. For internal auditors it is more difficult to achieve independence because they are actually employees of the organization they audit [3]. Thus, this will make the auditors provide the objective report and reliable professional judgment on the auditing work to achieve the mandate given to them with integrity [11]. [18] said that independence is assessed regarding to the internal audit's report to the highest level, the unrestricted access of internal auditors and the performance of internal audit in the development of the company's process. The internal auditor may face independence issue as they are the staff of the organization, however the external auditor from National Audit Department do not face these problems as they report directly to the Auditor General [7]. [17] the internal audit function must be independent of the activities being audited and must also be independent from everyday internal processes, and must be able to exercise its assignment on its own initiative in all departments, establishments and functions of the organization.

**Whistleblowing Practice.** The practice of whistleblowing refers to the act of people who believe that the interest of the public is important and must be protected so that they get involved in reporting the wrongdoings in organizations [30]. The role of internal audit can also include promoting whistleblowing best practice, testing and monitoring systems and advising on change where and when needed. However, the ultimate operational responsibility for whistleblowing procedures lies with executive management, reporting to the board [19]. The whistleblowing practice has been implemented in Malaysia through the introduction of the WPA 2010. In Malaysia, the WPA 2010 is a law to combat corruption and other wrong doings by encouraging and facilitating disclosures of improper conduct in the public and private sectors, to protect persons making those disclosures from detrimental action, to provide for the matter disclosed to be investigated and dealt with and to provide for the remedies connected therewith [22]. Although the WPA 2010 has been established to protect the informer, the actual implementation remains low and the research conducted is limited [30].

A study by [27] shows that whistle blowing policy is among the least commonly used by the public-sector accountants and internal auditors in Malaysia. Due to that, the management in each organization should be more aware of the environment that will enhance the participation of employees to report wrongdoings. According to [28], organizations have an effective whistleblowing system but they do not implement the system. The effective system is only on paper but not in practice. In order to encourage more individuals to come forward and whistleblow the management must do extensive communications to increase auditors' awareness and confidence to blow the whistle when encounter frauds and misconducts. This is achievable if there is an effective internal audit in the organization.

When an auditor blows the whistle, there are positive and negative consequences to society, the individual whistle-blower and his/her audit firm. Positive societal effects could include the reduction of the cost to society, resulting from loss of shareholders' confidence and undermining of the capital markets, reduction of loss of jobs as a result of a closure similar to Enron, and also ensuring potential tax revenues to the government. In addition, the image of the profession will be highly regarded by society when the auditor acts in the public interest (Rawls' theory). Whistleblowing effectiveness influence on fraudulent financial reporting. Effectiveness can see from dimensions of employee conditions (internal auditor) willing to report violations, attitude of employees (internal auditor) the report, the whistleblowing Access [21].

#### **Underpinning theory**

Two theories could provide insights into identifying the antecedents of the internal audit effectiveness and form the bases for developing testable hypotheses. First, the institutional theory suggests that organizations are both influenced by and can influence the society in which they operate [16]; [23] and organizations are also shaped by wider cultural, social and symbolic elements that comprise its environment [16]. This theory clarifies how organizational practices and structures are shaped through changes brought about by pressure [25]). Several previous studies on the internal audit have adopted an institutional theory [5]; [4]; [25]. More specifically, [5] adopted the isomorphic perspective to investigate the internal audit in Saudi Arabia, and the institutional theory was employed to explain their findings regarding the establishments of the internal audit and the role of the government in promoting their development. The study provides insights into internal audit in developing countries where the equity market is underdeveloped [24]). Prior research suggests that institutional theory has validity in the internal audit research, both in developing countries [5] and developed countries [4]. [29] argued

that justice is seen as fairness when the allocation of resources in society is considered rationally as advantageous or disadvantageous.

An alternative theory known as the *Theory of Justice*, [29] puts forward two generally accepted principles which are 1) all individuals should be treated fairly, and 2) positions and offices in society must be open to all individuals, and equal access to opportunities in society must be granted to all individuals. [29] offers two concepts that underpin the notion of impartiality in providing fairness: 'original position' and 'veil of ignorance'. Under the original position viewpoint, people imagine themselves as being free and equal individuals who jointly agree upon and commit to principles of social and political justice. Under the veil of ignorance, it is presumed that individuals will be able to choose fairly (i.e. be ethical and unbiased) since they can ignore the influences of issues such as wealth, religious beliefs and intellectual ability, in order to be fair to everyone. Thus, we see that Rawls' theory focuses on the design of just institutions in society. Following [29] notion of justice, decision makers are expected to act with fairness, equity and impartiality and, in turn, the organisation and society should administer its rules in the same vein. Therefore, [2] argue that whistle-blowing in the audit context should be a voluntary act within the realm of free speech and the individual's perception of justice and fairness in society.

### Conclusion and suggestion for future research

This article contributes to the on-going public interest on the increasing trend of frauds, corruptions and mismanagement of public resources in government organizations from the internal audit perspective. The implementation of WPA 2010 to improve the internal audit in the public sector was discussed. However, as usually the case, the implementation does not necessarily ensure the effectiveness even though the main motivation for its implementation was to strengthen the internal audit. The real concern is whether the provision for whistleblowing protection under the law does encourage the act of engaging internal auditors particularly, in exposing fraudulent acts in organizations. One key question to address is whether the practices of whistleblowing contribute to increase the effectiveness of the public sector internal audit? The article provides a review of selected determinants of internal audit effectiveness which are internal audit quality, proficiency of auditors and independent of auditors in addition to the whistleblowing practice. Two related theories were also briefly discussed. These are the institutional theory and the justice theory. Based on the review presented a new study would be designed to examine the current level of whistleblowing practice in the public sector and to determine whether this practice acts as a moderator in the relationships between selected independent variables and the effectiveness of the public sector internal audit. The research framework would be developed based on the propensity to blow the whistle (Rawls Theory) and isomorphic perspective (Institutional Theory). The new study shall contribute to extend the existing literature and provides new insights to strengthen the public sector performance through internal audit.

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