

**T.C.**  
**ISTANBUL UNIVERSITY**  
**SOCIAL SCIENCES INSTITUTE**  
**DEPARTMENT OF MANAGEMENT**

**MASTER'S DEGREE**

**Factors Affecting the Internal Audit Quality:**  
**Empirical Evidence from Libyan Commercial Banks**

**Hisham MASSOUD**

**2510160331**

**THESIS ADVISOR**  
**DOÇ.DR. Evren Dilek ŞENGÜR**

**ISTANBUL – 2019**



T.C.  
İSTANBUL ÜNİVERSİTESİ  
SOSYAL BİLİMLER ENSTİTÜSÜ



YÜKSEK LİSANS  
TEZ ONAYI

ÖĞRENCİNİN;

Adı ve Soyadı : HISHAM MOHAMED ALI  
MOHAMED MASSOUD Numarası : 2510160331  
Anabilim Dalı /  
Anasanat Dalı / Programı : İŞLETME Danışmanı : DOÇ.DR.EVREN DİLEK ŞENGÜR  
Tez Savunma Tarihi : 12.06.2019 Saati : 12.00  
Tez Başlığı  
FACTORS AFFECTING THE INTERNAL AUDIT QUALITY EMPRICAL EVIDENCE FROM  
LIBYAN COMMERCIAL BANKS.

TEZ SAVUNMA SINAVI, İÜ Lisansüstü Eğitim-Öğretim Yönetmeliği'nin 36. Maddesi uyarınca yapılmış,  
sorulan sorulara alınan cevaplar sonunda adayın tezinin KABULÜNE OYBİRLİĞİ / OYÇOKLUĞUYLA karar verilmiştir.

| JÜRİ ÜYESİ                | İMZA | KANAATİ<br>(KABUL / RED / DÜZELTME) |
|---------------------------|------|-------------------------------------|
| PROF.DR.RECEP PEKDEMİR    |      | KABUL                               |
| DOÇ.DR.EVREN DİLEK ŞENGÜR |      | KABUL                               |
| DOÇ.DR.NERMİN ÇITAK       |      | KABUL                               |

| YEDEK JÜRİ ÜYESİ          | İMZA | KANAATİ<br>(KABUL / RED / DÜZELTME) |
|---------------------------|------|-------------------------------------|
| DOÇ.DR.NERGİS NALAN YAKAR |      |                                     |
| DOÇ.DR.AYÇA AKARÇAY ÖĞÜZ  |      |                                     |

Versiyon: 1.0.0.2-61559050-302.14.06

## **Abstract**

### **Factors Affecting the Internal Audit Quality: Empirical Evidence from Libyan Commercial Banks**

**Hisham MASSOUD**

The objective of this study is to identify the factors that affect the quality of the internal audit in Libyan commercial banks. The study data were collected through 30 questionnaires distributed to internal auditors in Libyan commercial banks. The researcher used preprocessing method in Matlab to analyses the data. The results of the study indicate that the most important factors affecting the quality of internal auditing in Libyan commercial banks from the perspective of the internal auditors participating in this study include the following; Experience, training and independence of internal auditors (respectively). While some participants believe that administrative support and department size are less influential in the quality of internal audit in Libyan commercial banks. The study recommended that Libyan commercial banks should ensure the availability of the main factors to achieve the quality of the internal audit function.

**Key Words:** Internal Audit Quality, Libyan Commercial Banks, Factors.

## ÖZ

### **Denetim Kalitesini Etkileyen Faktörler: Libya Bankaları Üzerine Ampirik Bir Çalışma**

**Hisham MASSOUD**

Bu çalışmanın amacı Libya Bankalarında iç denetimin kalitesini etkileyen faktörlerin belirlenmesidir. Çalışmada Libya bankalarında çalışan 30 iç denetçi ile anket yapılarak veri toplanmış ve analiz yapılmıştır. Verilerin analiz edilmesi için Matlab programında ön işleme (preprocessing) yöntemi kullanılmıştır. Analiz sonuçlarına göre; araştırmaya katılan iç denetçiler açısından Libya bankalarında iç denetim kalitesini etkileyen en önemli faktörler sırasıyla; deneyim, eğitim ve iç denetçinin bağımsızlığıdır. Bununla birlikte iç denetçiler, işletme yönetiminin desteği ve iç denetim departmanının büyüklüğünün Libya bankalarında iç denetim kalitesini daha az etkilediğini düşünmektedir. Çalışma sonucunda, Libya bankalarının iç denetim kalitesini etkileyen unsurlara daha çok önem vererek, iç denetimin kalitesini artırması önerilmektedir.

**Anahtar kelimeler:** iç denetim kalitesi, Libya Bankalarında, faktörlerin.

## **ACKNOWLEDGEMENT**

The internal audit department is considered one of the most important departments in the Libyan commercial banks, as it plays an important and vital role in managing the risks, preserving the bank's assets and assisting the management in achieving its objectives. Therefore, this study came to know the factors that affect the quality of the internal audit from the point of view of the internal auditors. To achieve the objective of the study, the researcher designed a questionnaire consisting of 35 questions distributed to 30 Internal Auditors in the Libyan commercial banks.

I would like to express my deepest thanks and sincere appreciation to a number of special individuals, who support me to complete this thesis. I would first like to express my special gratitude thanks and appreciation to my supervisor, DOÇ. Dr. Evren Dilek ŞENGÜR who gave me support and encouragement and guided me patiently throughout my research.

Special thanks and appreciation go to my country Libya and to my sponsor Sabha University and the Faculty of Economics and Political Science for giving me the opportunity to pursue my postgraduate studies, and special respect and appreciation to Istanbul University for supporting me and providing a range of helpful facilities and services. I am grateful to all who participated in the study, for giving up their precious time to assist me in this research. I am also thankful to my brothers and sisters and to my dear friends for encouraging and helping me to achieve my goals.

I would also like to thank my mother, father, wife and my children for their patience and emotional support throughout this work. Thank you so much for your love all of you.

Hisham MASSOUD  
ISTANBUL, 2019

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## **LIST OF ABBREVIATIONS**

| <b>SYMBOL</b> | <b>FULL TERM</b>                               |
|---------------|------------------------------------------------|
| <b>AC</b>     | : Audit committee                              |
| <b>BD</b>     | : Board of directors                           |
| <b>BIS</b>    | : Bank for International Settlements           |
| <b>CBL</b>    | : Central Bank of Libya                        |
| <b>CEO</b>    | : Chief Executive Officer                      |
| <b>CG</b>     | : Corporate Governance                         |
| <b>EAs</b>    | : External Auditors                            |
| <b>IA</b>     | : Internal audit                               |
| <b>IAD</b>    | : Internal Audit Department                    |
| <b>IAs</b>    | : Internal Auditors                            |
| <b>IAS</b>    | : International Accounting Standard            |
| <b>IIA</b>    | : Institute of Internal Auditors               |
| <b>LAAA</b>   | : Libyan Accountants and Auditors' Association |
| <b>LCBs</b>   | : Libyan Commercial Banks                      |
| <b>LD</b>     | : Libyan Dinar                                 |
| <b>MENA</b>   | : Middle East and North Africa                 |

## **INTRODUCTION**

There is no doubt that internal auditing is an important part of corporate governance structure of the institution. This importance has been emphasized by the Institute of Internal Auditors. The internal auditor has a significant role in the ethical culture of the organization. The practice of the Institute of Internal Auditors 2130-1 emphasizes the need for internal auditors to play an active role in supporting the ethical culture of the Organization. The Internal Audit Department works to protect the Company's assets and increase awareness of the Organization's management in order to increase the efficiency of internal control over everything related to the Organization financially and administratively. The internal audit department establishes the basis for evaluating the risks that may arise in the institution and gives priority to financial risks of relative importance. The processes of modern banks are becoming increasingly complex, prompting the heads of organizations to ensure that their staff has sufficient professional competence to perform their duties properly. The Internal Audit Department is the most significant part of the banks. This is important because it serves as a safety valve for the company that maintains the stability of public activity and ensures compliance with the Bank's policies and procedures. The Internal Control Department is responsible for implementing policies and procedures determined by senior management and the Board of Directors. The internal audit department monitors the internal control system of banks. It is very important that banks have an effective internal control function so that banks can ensure that goals and objectives are met.

The banking sector is one of the most important sectors of the economy in most of the world and one of the main financiers of projects and institutions. Commercial banks are considered the most important financial institutions in terms of role, size, geographic spread, and range of services provided to customers. Commercial banks perform a number of vital functions, such as playing the role of intermediary between savers and borrowers, mobilizing savings, facilitating the flow of payments, allocating credit, and controlling the financial discipline of borrowers. As well as the provision of electronic banking techniques such as payment of invoices and update credit data and the withdrawal and transfer of funds. The main uses of bank funds are loans,

securities and reserves. Because of financial liberalization, globalization and technological innovation, management and operation have evolved over the last three decades. , Although these improvements have brought many benefits, they have created a high degree of uncertainty, thus increasing the risk of banks. The increased risk to banks forced banks and central banks to devise new risk management techniques and increase the importance of internal control and internal audit.

Economic crises in the past have resulted from many financial crises and many financial crises resulting from the failure of financial intermediaries. Due to the expansion of international business between the two countries, the economic and financial crisis in one country still exists but is widespread all over the world. Recently, many international meetings and conferences have been held to stabilize the global banking system because of the importance of this sector in achieving a strong and sustainable economy. In 1974, a group of ten governors of the world's largest central banks established the Basel Committee on Banking Supervision (BCBS). In 1988, the BCBS arranged Basel I for the development of rules and regulations for the international banking system. Basel I requires international banks to maintain at least 8% of the capital ratio. In 2004, the Basle Committee recommended the issuance of Basel II in response to the rapid and frightening development of the banking sector. According to the Bank for International Settlements (BIS) website, the major goal of Basel II is to control the amount of capital the bank should maintain to secure operational and financial risks. Basel III was subsequently released in response to the 2007-2009 financial crisis, according to the BIS website; Basel III's objective is to propose a regulatory framework for stress testing, market liquidity risk, and capital adequacy. Due to the consistent work of the Basel committees, attention and focus on the internal audit and oversight function have increased.

First, the researcher starts with an introduction to the study. Chapter one provide important information about internal audit such as; historical development, definition and importance of internal audit. The chapter also provides Internal Audit Quality, as well as factors affecting IAQ. In the second chapter, many aspects of Libya's context were highlighted and discussed. Background on Libya, including the Accounting and

Auditing Profession in Libya was presented. The role of the Central Bank of Libya (CBL) was highlighted as the main regulator and supervisory body and the Bank of Banks. The main issues surrounding the Libyan commercial banks were highlighted, such as, obstacles faced by the Libyan banking sector. In addition, the chapter also highlighted the development of Islamic banks in Libya. Chapter three introduces the study, and highlighted the Problem statement and objectives, and the hypotheses of this study. In addition, the chapter discusses the research methodology and methods that are adopted in this study, presents the results from the data collection and analyses these results. Finally, the overall conclusion of the study was presented.



# CHAPTER ONE

## CONCEPTUAL FRAMEWORK OF INTERNAL AUDIT AND INTERNAL AUDIT QUALITY

### 1.1. Conceptual Framework of Internal Audit

#### 1.1.1. Historical Overview of Internal Audit

The demand for both external and internal audits arises from the need for some independent means of confirmation to reduce record-keeping errors, misappropriation of assets and fraud within commercial and non-commercial companies. The need for effective controls created the concept of internal audit. However, many companies and external auditors did not recognize internal auditing as an important process until the 1930s, although it was rooted. This recognition was mainly due to the creation of the Securities and Exchange Commission (SEC) in 1934 and changing the objectives and techniques of external audit at that time. The world in general and the United States in particular experienced great economic tension. The Securities and Exchange Commission asked all registered institutions to provide certified financial statements from independent auditors as a corrective action, which prompting companies to establish internal audit departments first.<sup>1</sup> At that time, the focus of the external financial auditors was to express an opinion on the integrity of the financial statements of the institution, rather than to detect weaknesses in internal control or even written errors. The SEC rules have accelerated scrutiny on a limited sample of transactions, as well as increased reliance on internal control procedures.<sup>2</sup>

Walter B. Meigs wrote, during the 1930s, on the state of internal auditors, noting, *"Internal auditors were either charged with the routine task of constantly searching for written errors in accounting documents, or were traveling with representatives of*

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<sup>1</sup> Gupta, P. P., & Ray, M. R. (1992). The changing roles of the internal auditor. *Managerial Auditing Journal*, 7(1). P.3.

<sup>2</sup> Brink, V. Z., & Witt, H. (1982). *Modern Internal Auditing*, New York: A. p. 5.

*companies with branches in locations that were widespread Wide."* The remains of this definition continued in some places until the early 1970s.<sup>3</sup>

After World War II, Victor Z. Brink published his dissertation on internal auditing and as the first edition of the "Modern Internal Audit". Brink and Lawrence B. Sawyer, 6 years, respectively, presented by Victor G. as a leading figure in internal auditing in the 20th century. Brink was the first research director at the Institute of Internal Auditors (IIA) and was instrumental in issuing the Internal Auditor's Statement of Responsibilities in 1947.<sup>4</sup>

The Chairman of the Research Committee Lawrence Sawyer successfully reviewed the Statement of Responsibilities in 1971. A few years later, the responsibilities statement was further revised several times due to the rapid development of the IA profession.<sup>5</sup> The Standards for the Professional Practice of Internal Auditing (SPPIA) was formally approved by the IIA in 1978.<sup>6</sup> In 1996, an audit ethics manual was issued by the IIA. Then, in 1999, a new manual was prepared by the IIA to define the IA, which is defined as a qualitative, advisory and objective activity within the institution designed to review and improve the achievement of objectives. In addition, to evaluate and improve the effectiveness of risk management, control, and governance processes by ensuring the implementation of objective policies, plans and procedures.

As companies become larger and more complex, and thus the management capacity to monitor their operations is limited, the role of internal audit functions (IAF) has increased.<sup>7</sup> Often, the IAF acts as a subsidiary function of the accounting function and conducts accounting audits. The IAs usually has a type of quality control function, for example, to confirm that the organization's accounting processes are performed

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<sup>3</sup> Moeller, R. R. (2005). *Brink's modern internal auditing*. John Wiley & Sons. Incorporated. P. 5.

<sup>4</sup> Brink, Witt, op. cit., p. 6.

<sup>5</sup> Gupta, Ray, op. cit., P. 4.

<sup>6</sup> Ramamoorti, S. (2003). Internal auditing: history, evolution, and prospects. *Research opportunities in internal auditing*, 1-23.

<sup>7</sup> Sawyer, L. B. (1996). *Sawyer's internal auditing: the practice of modern internal auditing*.

correctly according to the instructions and standards.<sup>8</sup> External auditors (EAs) continued to strongly influence the work and approach of IA, from the perspective of the EAs function, as a guarantee of a reliable financial statement.<sup>9</sup>

### 1.1.2. Definition of Internal Audit

The starting point for the internal audit theory is the definition of IA. When writing about any subject, you must select the area covered. There are many different definitions of the IA, which were created by different IA related bodies over a period. The first definition of IA was developed by the IIA in 1947, which explained that IA aims to review and assess the effectiveness of the financial system and current accounting as a function as well as management and other controls within the organization.<sup>10</sup> IA is, therefore, an administrative control tool that monitors the effectiveness of the organization's systems and processes and safeguards that all the required purposes are met.<sup>11</sup>

The Institute of Internal Auditors submitted another revised version of the Strategic Impact Assessment in 1971. Further changes were made and each specific reference to accounting and financial auditing was dropped. This definition shows that the IAF has been expanded to allow internal auditors to gain a broader understanding of the organization's activities, where it can be in service at any administrative level.<sup>12</sup>

In 1981, the Institute of Internal Auditors issued a new definition to include additional details of the IAF.<sup>13</sup> By definition, the objective of the internal auditor should be to

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<sup>8</sup> Courtemanche, G. (1991). How has internal auditing evolved since 1941?. *Internal auditor*, 48(3), 106-110.

<sup>9</sup> Swinkels, W. H. A. (2012). *Exploration of a theory of internal audit*. Eburon Uitgeverij BV. P.28.

<sup>10</sup> Mousa, F. R. (2005). *Developing a model for evaluating the effectiveness of the internal audit function in Libyan organisations: case study with special reference to oil companies* (Doctoral dissertation, Manchester Metropolitan University). P. 40.

<sup>11</sup> Coram, P., Ferguson, C., & Moroney, R. (2006). The value of internal audit in fraud detection. *Journal of Accounting and Finance*, 48(4), 543-59.

<sup>12</sup> Mousa, op. cit., P. 40.

<sup>13</sup> Algeru, O. I. A. M. (2011). *Perceptions and evaluations of internal audit function in Libyan oil and gas companies*(Doctoral dissertation, University of Gloucestershire). P. 27.

increase the effectiveness and maximize the Organization's resources under the current circumstances. As well as providing advice and information to assist management in meeting its responsibilities.<sup>14</sup> In 1999, the IIA add a new definition of IA:<sup>15</sup>

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

This definition was issued after a study of 800 students, coordinated by auditors from Australian universities.<sup>16</sup> This definition indicates that an internal audit has shifted from a focus on accountability over the past to improving future results to help audits work more effectively and efficiently.<sup>17</sup>

### **1.1.3. Importance of Internal Audit**

The main role of internal auditing is to add value to the institute by performing assurance and consulting activities. There is increasing awareness of the importance of the value-added role that IA can play in modern organizations.<sup>18</sup> Internal audit department is generally responsible for;<sup>19</sup>

- Evaluating of asset safeguards;
- Investigations into fraud;
- Assessment of internal controls;
- Performance of the review and appraisal process;
- Audit of accounting and financial information.
- Confirm and review compliance;
- Evaluation of usage resource efficiency.

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<sup>14</sup> Spencer Pickett, K. H. (1997). The internal auditing handbook. John Willey & Sons, New York, Chichester, str, 228. P. 3.

<sup>15</sup> Algeru, op. cit., P. 27.

<sup>16</sup> Petraşcu, D. (2010). INTERNAL AUDIT: DEFINING, OBJECTIVES, FUNCTIONS AND STAGES. *Studies in Business & Economics*, 5(3). P. 240.

<sup>17</sup> Nagy, A. L., & Cenker, W. J. (2002). An assessment of the newly defined internal audit function. *Managerial Auditing Journal*, 17(3), 130-137.

<sup>18</sup> Al-Twajry, A. A., Brierley, J. A., & Gwilliam, D. R. (2003). The development of internal audit in Saudi Arabia: an institutional theory perspective. *Critical Perspectives on Accounting*, 14(5), 507-531.

<sup>19</sup> Staciokas, R., & Rupsys, R. (2005). Internal audit and its role in organizational government. *Organizacijø Vadyba: Sisteminiai Tyrimai*, (33), 169.

The European Union (EU) Commission has confirmed that the IAF is part of the internal control system and that its role may shift from a financial focus to an administrative one as well. In order to confirm its role effectively, it should apply the following principles:<sup>20</sup>

- General conditions;
- Establish conditions for staff selection;
- Developing auditing practices;
- Training and professional development of staff.

To ensure the success of the control system, the Committee stressed the urgent need for an effective IAF, with the following benefits:<sup>21</sup>

- Ensuring continuity in the oversight process: Since the evaluation, recommendations and reports prepared by the internal audit are: on a continuous basis during the year, Satisfaction to their owners, and continuity enables the management to implement reforms and improvements in a timely manner.
- Precise construction provisions: When internal auditors are familiar with the system, they can combine professional skills with accurate judgments about system efficiency, effectiveness, and management of predefined objectives.
- Contribute to ensuring the quality of the system: including compliance with internal policies, procedures, and regulations to ensure that the objectives of the system are achieved in an economical and effective manner, IAs have an important oversight role in ensuring compliance with those procedures and internal regulations.
- Service delivery system: Internal auditors are uniquely positioned to provide management through analysis, evaluation, and recommendations, and IA can provide support to improve the quality of corporate governance quality.

Although the definition of internal auditing may vary from decade to decade, we are currently faced with some difficulties in understanding the IAF and its significance in the system.<sup>22</sup> IA activity is no longer confined to being an internal control tool or

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<sup>20</sup> Al Matarneh, G. F. (2011). Factors determining the internal audit quality in banks: Empirical Evidence from Jordan. *International Research Journal of Finance and Economics*, 73, 99-108.

<sup>21</sup> Al Matarneh, op. cit., pp. 99-108.

<sup>22</sup> Spira, L. F., & Page, M. (2003). Risk management: The reinvention of internal control and the changing role of internal audit. *Accounting, Auditing & Accountability Journal*, 16(4), 640-661.

merely a systematic audit tool to ensure the value of internal control, verification of manipulation, or the assistance of the EAs only, but has become wider and more inclusive than this traditional understanding. In order to achieve and take full advantage of the internal audit function, other parties to the system must have enough understanding of the audit function.<sup>23</sup>

#### **1.1.4. Internal Audit and Agency Theory**

The agency theory can be described as an agreement between the owners and the senior management of the organization. The owners authorize some managers to represent them in the company on their behalf to implement certain services and delegate some decision-making powers to managers. Managers to meet their own personal interests could misuse these authorities. For that reason, the presence of external and internal auditors and audit committees will assist the corporation in improving its performance and guarantee that the department implements its arrangements in accordance with the procedures.<sup>24</sup>

Internal auditors are considered as proxies and observers for a group of IA users, including the Board of Directors (BD), the Audit Committee (AC) and senior management. Agency problems may arise once the board of directors or its audit committee is ineffective, consequently, it is expected that there will be a strong impact of senior management on internal audit. Problems may also arise because of the adverse selection of agents, either because shareholders hire agents, who lacks the necessary skills, or because they do not know enough about candidates or because the contracting process itself is flawed.<sup>25</sup> This complexity creates uncertainty about IA

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<sup>23</sup> Staciokas, Rupsys, op. cit.

<sup>24</sup> Ashour, M. S. R., Sukoharsono, E. G., & Ghofar, A. (2015). The Impact of Competencies, Risk Management and Auditors Interactions on Internal Audit Effectiveness in Libyan Commercial Banks. *The International Journal of Accounting and Business Society*, 23(1), 1-20. P. 4.

<sup>25</sup> Gomez-Mejia, L. R., & Wiseman, R. M. (2007). Does agency theory have universal relevance? A reply to Lubatkin, Lane, Collin, and Very. *Journal of Organizational Behavior*, 28(1), 81-88.

capabilities; however, will it do its part in monitoring management if it is not effective in itself.<sup>26</sup>

The theory of the agency is wide employed in accounting literature to illuminate and anticipate the designation and performance of external auditors. Some researchers argue that the agency theory is also valuable for studying the IAF by providing a theoretical framework for it. They suggest that the agency theory, besides helping to explain and anticipate internal audit, also helps to clarify the role and tasks of the internal auditors of the corporation and expects how the IAF will be affected by organizational exchange.<sup>27</sup>

The importance of Agency theory was recognized in the Libyan Corporate Governance Code (2010), which requires all banks to set up such a committee to monitor managers and protect the interests of shareholders (CBL, 2010a). Agency theory aims to reduce the resulting agency costs by improving the information quality flow between managers and shareholders and avoiding conflict.<sup>28</sup> A lack of relevant research means that it is unsure whether agency problems in the Libyan banking sector are the result of conflicts in the owner-manager relationship or in the relationship between majority and minority shareholders.<sup>29</sup>

### **1.1.5. Internal Audit in Banking Sector**

In accordance with Basel II (2012) standards for the internal audit function of banks, boards of directors must confirm that auditors have necessary knowledge to investigate

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<sup>26</sup> Ittonen, K. (2010). A theoretical examination of the role of auditing and the relevance of audit reports. P. 14.

<sup>27</sup> Adams, M. B. (1994). Agency theory and the internal audit. *Managerial auditing journal*, 9(8), 8-12.

<sup>28</sup> Samaha, K., Dahawy, K., Hussainey, K., & Stapleton, P. (2012). The extent of corporate governance disclosure and its determinants in a developing market: The case of Egypt. *Advances in Accounting*, 28(1), 168-178.

<sup>29</sup> Alrshah, A. M., & Fadzil, F. H. (2013). The impact of Corporate Governance reforms on External Auditor Quality and Reliability of Audited Financial statements: Evidence from Libya. In *International Conference on Business Innovation, Entrepreneurship and Engineering (ICOBIEE2013)* (Vol. 6).

each unit and department of the bank. The IA division should not participate in the development of plans and measures for internal control, as this may impair its objectivity. However, when the Board of Directors requests the auditor to provide advice and suggestions for improving or evaluating certain parts of internal control, the auditor can provide assistance. The internal audit function at Basel (2012) in the banks states that internal audit staff must be alternated to other banks' departments in order to break routine work that may reduce its objectivity. The work of auditors in the audit department for a long time may harm their objectivity and independence. For example, in Turkey, IA staff cannot work in the audit department for more than 8 years.<sup>30</sup>

The banking sector is one of the fastest growing financial institutions in most countries. This rapid development complicates banking activities. Employees must have professional competence related to their work so that they can carry out their work in accordance with ethical and professional values and behaviors.<sup>31</sup>

The BD and the Head of Internal Auditors must guarantee that internal audit staff is trained from time to time so that they can keep pace with development and must ensure that they have sufficient knowledge of the best audit methods used.<sup>32</sup> Internal auditors have the right to review any section in the institute and obtain any kind of information they need to do their duties properly. On the other hand, as a condition of ethics, they are not entitled to use this information to achieve any kind of personal gain or immoral act. In order to improve ethics related to the profession, banks must apply Code of Ethics to auditors or require auditors to acquiesce with international standards such as those issued by the IIA or International Standards on Auditing (ISA). In accordance with the Basel Standards on Internal Auditing, the Code of Ethics must at least address the principles of objectivity, competence, confidentiality and integrity. The BD and

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<sup>30</sup> Argun, A. (2016). *An Analysis of the Internal Audit and Internal Control Systems of Banks in TRNC* (Master's thesis, Eastern Mediterranean University (EMU)-Doğu Akdeniz Üniversitesi (DAÜ)). P. 26.

<sup>31</sup> Chartered Banker Professional Standards (2014). Framework for Professional Standards. Chartered Banker Professional Standards, P. 4.

<sup>32</sup> Burnaby, P., & Hass, S. (2009). A summary of the global Common Body of Knowledge 2006 (CBOK) study in internal auditing. *Managerial Auditing Journal*, 24(9), 813-834.

senior management can make better use of IA results if they are based on professional ethics.<sup>33</sup>

Obtaining a written, clear, updated and comprehensive audit charter is the best way for bankers to improve and better utilize internal audit. As stated by the IIA “The Internal Audit Charter is an official document that defines the purpose of internal audit activity, authority, and responsibility”.<sup>34</sup> The Basel Standard on Internal Auditing states that all banks are responsible for the existence of an internal audit charter that sets the auditor's objective, position and strength within banks. It also states that the internal audit charter must include the status, authority, responsibilities and relationships with the other oversight unit, the objective and scope of the audit, and the responsibility of the internal audit chief. Periodically, the Internal Audit Charter must be updated and compliance with international standards must be complied with.<sup>35</sup> In order to obtain good and reliable response from IA reports, each movement and unit of the Bank must be in the scope of the auditor's activity.

#### **1.1.6. Internal Audit Profession in Libya**

There is no special organization for internal auditors in Libya like in the US and some other states. In contrast, the Libyan Commercial Law of 1953 forces all Libyan public companies to establish an IA department controlled by a director. As well as appointing EAs to check their financial statements.<sup>36</sup> In 1955, the Treasury Ministry of Libya set up the State Accounting Bureau (SAB) under the Law No: 1955/35. Later, in 1988, the SAB and the Public Control Institute (IPC) were combined to ensure that all national and foreign companies operate in accordance with Libyan laws and regulations. In 1973, Law No. 116 was issued to regulate accounting and auditing standards. In accordance with the same law in 1975, the Government established the

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<sup>33</sup> Basel Committee on Banking Supervision, op. cit.

<sup>34</sup> Chartered Institute of Internal Auditors (2018). Available at: <file:///C:/Users/TOSHIBA/Desktop/Internal%20audit%20charter.pdf.pdf>. Accessed on 08 August 2018].

<sup>35</sup> Idiab, A. I. M., Haron, M. S., & Ahmad, S. (2011). Internal auditing in commercial banks. *International Business Management*, 5(6 A), 287-294.

<sup>36</sup> Abo-Azza, W. O., Mihret, D. G., James, K., & Best, P. (2015). The perceived scope of internal audit in Libyan public enterprises. *Managerial Auditing Journal*, 30(6/7), 560-581.

Libyan Accountants and Auditors Association (LAAA) with the aim of increasing the standards of accountants and auditors professionally.<sup>37</sup>

According to the Legal Law No. 116/1973 (sub-section 32), the auditor should register with the Institute of Chartered Accountants (LAAA) before being able to act as an auditor. To register at the LAAA Institute, you must have a Libyan citizenship, have a Bachelor of Accounting and have practical experience in accounting and auditing for a period of five years after graduation. You may obtain it by working in an independent Accounting and Auditing Office.<sup>38</sup> In 2006, the LAAA established the first exposure draft of Libyan Accounting Standards (LAS) which involved 29 accounting standards based on IASs.<sup>39</sup> With regard to international standards of auditing, because there are no professional bodies related to internal auditing in Libya that can encourage companies to adopt ISAs, they are not formally binding and are not applied in many Libyan companies. In terms of IFRS, Legal (2012) stated that it is binding on companies listed on the Libyan stock market, but these companies face many obstacles due to the apparent lack of qualified accountants and auditors.<sup>40</sup>

## **1.2. Internal Audit Quality (IAQ)**

IAQ is the extent of conformity with the requirements, as organizations seek to monitor performance, activities and daily work to achieve the highest degree of quality, by reducing errors and detecting deviations in a manner that meets the needs of management with regard to the quality of internal audit based on the good performance of the internal control system.<sup>41</sup>

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<sup>37</sup> Ahmad, N. S., & Gao\*, S. S. (2004). Changes, problems and challenges of accounting education in Libya. *Accounting Education*, 13(3), 365-390.

<sup>38</sup> Sawan, N., & Alzeban, A. (2015). Does Audit Quality in Libya Meet the International Standards Levels?. *International Journal of Business and Management*, 10(6), 156-167.

<sup>39</sup> Masoud, N. (2016). The Development of Accounting Regulation in the Libyan Region Countries in Africa. *Development*, 7(12). P. 48.

<sup>40</sup> Ibid., P. 50.

<sup>41</sup> Belkhadem, H. (2016). Impact of Internal Audit Quality on Corporate Governance: a case study of Al - Ziban Al - Qantara Mills Est. (Master's thesis, Mohammed Khaydar University – Sakra). P. 32.

### 1.2.1. Importance of Internal Audit Quality

IAQ helps individuals within the organization to carry out their duties with a high degree of efficiency through achieving the main objective of the internal audit, which is the periodic evaluation of financial, accounting, administrative and executive procedures related to it and make sure that it goes according to plan.<sup>42</sup>

The main factor in considering the use of IA in the EA process is the IAQ. The (SAS 65) Standards set internal audit quality limits as follows: 1. Average years of experience, and percentage of internal auditors and experts in IA (efficiency). 2. Report to the Executive Director of Audit (objectivity). 3. The time spent by the internal audit in assisting external audit, and the time spent by the internal auditor in the performance of audit functions (work-performed quality). In the same way, the IIA standards set the quality factors for auditing functions through efficiency, independence and objectivity.<sup>43</sup>

Previous studies indicate that the external auditors' reliance on IA work will increase further if the Internal Audit Section has competency-related characteristics. These researches concentrate on the use of exact standards to assess the efficiency of the IAF, including the size or existence of IAF, IA training plans, professional certification, and IA experience.<sup>44</sup>

Some researchers found that the use of Information technology (IT) makes major changes in IA. As stated by these results, IT is used to implement the various stages of internal audit, in particular content testing and in the process of conducting analytical investigations and key processes. Based on these outcomes, reviewers can increase their benefits and obligations with higher quality using IT. Audit helps improve the quality of various aspects of IA. Software packages, comprehensive electronic papers and other programs such as planning programs provide the ability to

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<sup>42</sup> Ibid., P. 32.

<sup>43</sup> Institute of Internal Auditors (IIA). (2003b), "International standards for the professional practice of internal auditing" Institute of Internal Auditors.

<sup>44</sup> Goodwin-Stewart, J., & Kent, P. (2006). The use of internal audit by Australian companies. *Managerial Auditing Journal*, 21(1), 81-101.

improve internal audits. Research results also indicate that IT use makes auditors perform faster and take less time to search for, test content and mathematical calculations quickly.<sup>45</sup>

## **1.2.2. Factors Affecting Internal Audit Quality**

### **1.2.2.1. Internal Auditors' Independence**

The independence of the internal auditor means his ability to make impartial, objective and impartial decisions in his review and evaluation without any kind of pressure from the internal or external authorities. The Standards of the IIA for the Professional Practice of Internal Auditing define the internal auditors' independence as follows:<sup>46</sup>

*"Freedom from circumstances that threaten objectivity or the appearance of objectivity. These threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels"*

The IIA, the American Institute of Certified Public Accountants (AICPA) and others consider the independence of IAs to be essential to the continuity of the IAF. The IIA published a number of attribute criteria under which the IIA discovered the criterion of independence and objectivity 1100 in ISPPIA. This standard provides that IA activity have to be independent in the performance of its work.<sup>47</sup> The services provided by the IA management are valued and credible by the independence of their staff in their thinking and impartiality in decision-making. The desired results of the internal audit can not be achieved if it was devoid of independence.<sup>48</sup>

The power of the IAD is measured in accordance with the level of internal audit independence of management and other operational responsibilities. Internal auditors' independence increases the effectiveness of the internal auditor since this

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<sup>45</sup> Salehi, M., & Husini, R. (2011). A study of the effect of information technology on internal auditing: Some Iranian evidence. *African Journal of Business Management*, 5(15), 6168-6178.

<sup>46</sup> Institute of Internal Auditors (2011d), International Standards for the Professional Practice of Internal Auditing.

<sup>47</sup> Ibid.

<sup>48</sup> Vanasco, R. R. (1996). Auditor independence: an international perspective. *Managerial Auditing Journal*, 11(9), 4-48.

independence may decrease the level of struggle between employer loyalty and loyalty to certain managers, and give auditors an encouraging environment in which they can carry out their tasks with no pressure.<sup>49</sup> Therefore, IAs must be necessarily independent of the audited entity so that they can perform their work impartially and without any interference.<sup>50</sup>

### **1.2.2.2. Training of Internal Auditors**

Mihret, James, and Mula point out that continuous training and technical competence are essential for effective IA. The competence of IAs requires the knowledge, professionalism and experience, which gained from continuing education and training during work.<sup>51</sup> Consequently, legislators have set out the necessary obligations that need to be met as succeeded persons and entitled to audit:<sup>52</sup> (1) Workers will be able to behaviour useful audits that significantly contribute to organizational objectives. (2) The experience and efficiency of the IAs will rise the likelihood that EAs will use the work of the internal auditors, guiding to a decrease in the external audits cost; and (3) IAs who have knowledge of the audited entity are ideally placed to give information about the monetary statements.

IAs are required to acquire many different skills, for instance, communication, personality and technical knowledge in auditing and IT.<sup>53</sup> ISPPIA (1210) stated that, IAs should have the knowledge, skills and other capabilities necessary to implement their duties. IA departments must have IAs with a large amount of skills to authorise them to conduct audits that go beyond the areas of financial activity.<sup>54</sup>

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<sup>49</sup> Bou-Raad, G., & Capitanio, C. (1999). The implications of computer hacking on the internal audit function: a banking industry study. *INTERNAL AUDITING-BOSTON-WARREN GORHAM AND LAMONT INCORPORATED-*, 14, 36-41.

<sup>50</sup> Cohen, A., & Sayag, G. (2010). The effectiveness of internal auditing: an empirical examination of its determinants in Israeli organisations. *Australian Accounting Review*, 20(3), 296-307.

<sup>51</sup> Mihret, D. G., James, K., & Mula, J. M. (2010). Antecedents and organisational performance implications of internal audit effectiveness: some propositions and research agenda. *Pacific Accounting Review*, 22(3), 224-252.

<sup>52</sup> Paape, L. (2007). *Corporate governance: The impact on the role, position, and scope of services of the internal audit function* (No. 111).

<sup>53</sup> Hass, S., Abdolmohammadi, M. J., & Burnaby, P. (2006). The Americas literature review on internal auditing. *Managerial Auditing Journal*, 21(8), 835-844.

<sup>54</sup> Abu-Azza, W. (2012). Perceived effectiveness of the internal audit function in libya. *University of Southern Queensland Australia*. P. 50.

Gramling and Myers believe that the internal auditors' certification is evidence of competence.<sup>55</sup> Auditing has become increasingly complex with the globalization of companies and the storage of information in computers. For that reason, in this new IT environment, the capability of internal auditors to work within this environment is very necessary. In order for the internal auditor to be valuable, internal auditors need continuous training and efficiency to achieve their quality and effectiveness, because skills affect the quality.<sup>56</sup>

### **1.2.2.3. Board of Directors' Support for Internal Audit**

The Standards of the IIA for the Professional Practice of Internal Auditing (1110 - Organizational Independence) recognize that top management and the Board of Directors must support IAs so that they can obtain the cooperation and performance of auditors without being subjected to any pressure or interference from any party. Therefore, the support of top management and the BD for auditors makes their work more effective. BD support is also significant for the IAD to monitor management risk.<sup>57</sup>

Walker, Shenkir, and Barton suggest that enterprise risk management may not function properly without strong institutional support from senior management or board of directors because internal auditors have a significant responsibility for identifying and evaluating risks and because of support they are likely to interact with senior management in implementation issues Risk Management. In addition, support for senior management is essential to the success of a variety of initiatives. Senior management support is reflected in the motivation provided by senior management of internal auditors. This may include the creation of training and educational programs to train internal auditors, adequate budget for the internal audit department, internal

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<sup>55</sup> Gramling, A. A., & Myers, P. M. (1997). Practitioners' and users' perceptions of the benefits of certification of internal auditors. *Accounting Horizons*, 11(1), 39.

<sup>56</sup> Burnaby, P., & Hass, S. (2009). A summary of the global Common Body of Knowledge 2006 (CBOK) study in internal auditing. *Managerial Auditing Journal*, 24(9), 813-834.

<sup>57</sup> Abu-Azza, op, cit., P. 76.

auditors' remuneration, and acceptance and implementation of internal audit recommendations.<sup>58</sup>

Group of researchers found that senior management is expected to implement the recommendations of the IAs if senior management is driven externally by following internal audit recommendations. Without this incentive and support, the internal auditor may not have sufficient strength to influence management when management procedures are insufficient. Management's approval of internal auditors' recommendations might improve the effectiveness of IA. Hence, the IAD may not be able to perform its work sufficiently and effectively without the suitable support of the entity responsible.<sup>59</sup>

#### **1.2.2.4. Size of Internal Audit Department**

Adequate resources should be provided to the Internal Audit Section to accomplish its responsibilities as required. In the Resource Management Standard, ISPPIA requests the Chief Audit Executive (CAE) to confirm that the IA Department has sufficient resources and are used effectively. Internal audit officers have the responsibility to notify top management of any resource shortfalls (ISPPIA, Standard 2030 and 2230). Convenient numbers of IAs should be employed (consulting practice 2030-1: Resource Management). Some research paper indicate that the IAQ work is liable to be higher when there is enough human resources. For instance, some researchers from Malaysia noted that the biggest problem facing internal auditing is the lack of sufficient qualified staff. Another study found that respondents classified the "small number of internal auditors" as the main issue impeding the success of the IAF in state-owned institutions in the country.<sup>60</sup>

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<sup>58</sup> Baharud-din, Z., Shokiyah, A., & Ibrahim, M. S. (2014). Factors that contribute to the effectiveness of internal audit in public sector. *International Proceedings of Economics Development and Research*, 70, 126.

<sup>59</sup> Burns, D. C., Greenspan, J. W., & Hartwell, C. (1994). The state of professionalism in internal auditing. *Accounting Historians Journal*, 21(2), 85-116.

<sup>60</sup> Ahmad, N., Othman, R., Othman, R., & Jusoff, K. (2009). The effectiveness of internal audit in Malaysian public sector. *Journal of Modern Accounting and Auditing*, 5(9), 53.

#### **1.2.2.5. Experience of Internal Auditors**

The IAD is one of the most important departments for the executive management of banks. The reason for this is that the development of the IA system enables banks to obtain reliable and sufficient information about their performance. As a result, the Board of Director can detect and prevent problems and risks previously. Internal auditors must be professionally qualified to conduct audit activities. It is important that the bank has a highly experienced team, as the banking sector is one of the fastest growing sectors in the economy. In addition, auditors must obtain appropriate and continuous training programs to cope with rapid developments in the banking sector.<sup>61</sup>

Some researchers believe that the experience gained by the auditors through everyday practice further enhances their knowledge. Some pointed out that the years of experience were indicative of the knowledge and experience of the auditors. Internal auditors need a large number of competencies to achieve satisfactory performance across hierarchies within internal audit departments.<sup>62</sup> Consequently, over the years, many programs have been designed in numerous developed countries such as (USA, UK, Canada, etc.) to enhance the internal audit quality professionals. For instance, The IIA provided relevant professional courses for IAs. In addition, other relevant professional organizations such as AICPA and others provided professional development courses in internal audit.

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<sup>61</sup> Argun, op. cit., P. 55.

<sup>62</sup> Burnaby, Hass, op. cit., pp. 813-834.

## CHAPTER TWO

### CONCEPTUAL FRAMEWORK OF LIBYAN BANKING SECTOR

#### 2.1. The Accounting and Auditing Profession in Libya

When the modern Libyan state was established in 1951, the country's economy depended on the agricultural sector and some primitive handicrafts.<sup>63</sup>

In 1953, Libyan Commercial Law was issued, which provides that all Libyan public corporations shall have an IAD headed by a director. In addition, All Libyan public companies are required to employ EAs to review their monetary statements for the purpose of taxation.<sup>64</sup> The law was a recognition of the importance of the function of accounting and auditing. Consequently, as oil exports increased during the 1960s, the government took several steps to improve accounting education at Libyan universities.<sup>65</sup>

Under law No 35/1955. The Treasury Ministry of Libya set up the State Accounting Bureau (SAB), which was joined with the Institute of Public Control (IPC) in 1988. This Institute was issued in order to confirm that all domestic and foreign companies working in Libya were operating in accordance with Libyan laws and regulations.<sup>66</sup>

With the discovery of oil in 1959, Libya was transformed from a poor country into a very rich country. Through its participation in the Libyan oil industry, the UK, USA, and other Western countries have introduced their accounting practices and attitudes

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<sup>63</sup> Younes, A., Kyriakidou, N., & Stewart, J. (2013). MTDPNA in non-oil international organisations in Libyan post crisis. *Business and Management Research*, 2(1). P. 20.

<sup>64</sup> Abu-Azza, W. (2012). Perceived effectiveness of the internal audit function in libya. *University of Southern Queensland Australia*. P. 26-28.

<sup>65</sup> El-Firjani, E., Menacere, K., & Pegum, R. (2014). Developing corporate accounting regulation in Libya past and future challenges. *Journal of Accounting in Emerging Economies*, 4(1), 22-56. P. 26.

<sup>66</sup> Masli, A. M. (2018). *The role of the audit committee as a corporate governance mechanism: the case of the banking sector in Libya* (Doctoral dissertation, Nottingham Trent University). P. 8.

towards accountability in the Libyan environment. These companies have positively influenced the development of accounting, especially in the Libyan oil companies and in other companies in general.<sup>67</sup> Libyan students who studied abroad, especially in the US and the UK formed early practice.

In 1973, the Government passed Law No. 116 as the next major step in the development of the accounting profession, which is the first legislation that focuses specifically on the profession of accounting and auditing.<sup>68</sup> One of the most important benefits of this law is the founding of the Association of Libyan Accountants and Auditors (LAAA). This law was limited to some organizational and ethical aspects of the profession, which does not reach the level of professional standards in its developed sense.<sup>69</sup>

The LAAA was founded in 1975 with the aim of reorganizing the profession of accounting and auditing, improving its working conditions and raising the standards of accountants and auditors in terms of professional, academic, cultural and political.<sup>70</sup> The basic professional qualification for accounting in Libya is the membership of LAAA, and also Auditors must be members of the LAAA to practice. Accountants who wish to qualify as members of the LAAA must meet the following requirements:<sup>71</sup>

- Must have Libyan citizenship.
- Have a Bachelor of Accounting in a minimum;
- Have five years of experience in accounting-related jobs in an accredited accounting office after obtaining a bachelor's degree;
- Be active in political and civil rights;
- Have good behavior, reputation and respect commensurate with the profession.

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<sup>67</sup> Masoud, N. (2016). The Development of Accounting Regulation in the Libyan Region Countries in Africa. *Development*, 7(12). P. 45.

<sup>68</sup> El-Firjani, Menacere, Pegum, op. cit., pp. 22-56.

<sup>69</sup> Ahmad, N. S., & Gao\*, S. S. (2004). Changes, problems and challenges of accounting education in Libya. *Accounting Education*, 13(3), 365-390. P. 369.

<sup>70</sup> Ibid., P. 369.

<sup>71</sup> Libyan Association of Accountants and Auditors 2010, *Membership Record, Tripoli*, (In Arabic). P. 172.

Some other qualifications recognized by the Council holds a doctorate in accounting or auditing from a Libyan or foreign university of high standing. These qualifications also include a certificate from the American Institute of Certified Public Accountants or the Institute of Chartered Accountants of England.<sup>72</sup>

Despite the existence of LAAA and other attempts at regulation, however, the accounting profession in Libya has yet to achieve its main objective of developing accounting practices. For example, audit practice is still not developed, making it difficult to report misconduct.<sup>73</sup>

To address this weakness, the Government issued Banking Law No. 1/2005 and required all companies with a capital of more than one million Libyan Dinars to be listed on the Libyan stock market. Where they are expected to follow the IASs. Such progress was largely due to the Libyan Central Bank, which sought to promote good accounting practices by issuing Corporate Governance (CG) guidelines and role.<sup>74</sup> At present, the profession of accounting and auditing does not enjoy a high status, mostly due to the noticeable weakness in the LAAA.<sup>75</sup> This situation is unlikely to change without a comprehensive reform of occupational regulations to bring them into line with those in developed countries.

## **2.2. The History of Libyan Commercial Banks**

As a consequence of Italian occupation from 1911 to 1943, the banking system in Libya was part of the Italian banking system and under the supervision and regulations of the Central Bank of Italy.<sup>76</sup>

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<sup>72</sup> Shareia, B. F. (2014). The Libyan accounting profession. *globalization*, 25(55), 78. p. 3459.

<sup>73</sup> Zakari, M., & Menacere, K. (2012). The challenges of the quality of audit evidence in Libya. *African Journal of Accounting, Auditing and Finance*, 1(1).

<sup>74</sup> Larbsh, M. M. (2010). *An evaluation of corporate governance practice in Libya: stakeholders' perspectives* (Doctoral dissertation, Nottingham Trent University).

<sup>75</sup> Masoud, N. (2017). An empirical study of audit expectation-performance gap: The case of Libya. *Research in International Business and Finance*, 41, 1-15.

<sup>76</sup> Kribat, M. M. (2009). *Financial disclosure practices in developing countries: evidence from the Libyan banking sector* (Doctoral dissertation, University of Dundee).

After the Second World War, Libya came under British military administration. During this administration, banking activities were limited to Barclays Bank, as well as to Italian banks, which resumed their activities after the end of the war. However, the main aim of these banks was to make profits without any intention to participate in any social or economic role in helping the Libyan society.<sup>77</sup>

In 1951 after Libyan independence, many foreign banks opened their branches in the country such as the British Bank for the Middle East and Bank of America. Four years later, in 1955, the Libyan government established the first Libyan bank, the Libyan National Bank. The main function of the Libyan National Bank was the issuance and managing currencies as well as commercial banking activities. Unfortunately, because of the dominance of foreign banks in the banking sector in Libya, the National Bank of Libya has failed to achieve its goals.<sup>78</sup>

In 1963, Law No.4 was passed by the Libyan government, which gave the National Bank of Libya the authority to regulate and control the Libyan banking system. As a consequence, most foreign banks were restructured and at least 51% of their capital was sold to the Libyan private sector.<sup>79</sup> However, the Bank of Napoli, the Bank of Rome, Al-Arab Bank and Barclays bank did not respond to the “Libyanisation”, and the process of “Libyanisation” was limited and did not include all banks operating in Libya at that time.<sup>80</sup>

At the beginning of the September Revolution in 1969, the Revolutionary Command Council (RCC) required that all banks and branches of foreign banks should be transferred to joint-stock companies and Libyans should control at least 51% of the

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<sup>77</sup> El-Shukri, A. S. (2007). *Non-financial performance measurement in the Libyan commercial banking sector: four grounded theory case studies* (Doctoral dissertation, University of Dundee).

<sup>78</sup> Central Bank of Libya 2006. „the Fiftieth Anniversary of the founding of the Central Bank of Libya - a special report.“ Tripoli: Central Bank of Libya.

<sup>79</sup> Masoud, A. M., & Al-Shrif, B. (2002). The Libyan commercial banks: the development and activation. *Journal of Arab Banks Union*, 259, 81-88.

<sup>80</sup> Central Bank of Libya, op. cit.

capital. In addition, most of its boards of directors were required to be Libyans, including the chairperson.<sup>81</sup>

However, in 1970, the Libyan government nationalized and purchased outright all foreign banks, and merged all banks into five commercial banks.<sup>82</sup> As a result, the Libyan government completely owned three of these banks, and the majority of the other two banks (more than 80%), and the private sector owned the remaining stake. These banks were National Commercial Bank, Gumphouria Bank (formerly Barclays Bank), Wahda Bank, Sahara Bank (formerly Bank of Sicily), and Ummah Bank (formerly the Bank of Rome). In addition to these commercial banks, the Libyan government established four specialist banks: the National Agricultural Bank, the Industrial and Real Estate Bank, the Libyan Development Bank, and the Libyan Arab Foreign Bank to serve the goals of the centrally planned economy which was adopted in Libya up to the mid of the 1990s.<sup>83</sup>

In 1993, the General People's Congress (GPC) issued Law No. 1, which allowed the private sector to contribute to the banking sector through the establishment of private commercial banks. Based on this law, many private banks have been established. The most important of in terms of banking services, Trade and Development Bank, has provided a high level of banking services such as ATMs, credit cards, telephone and online banking, while government-owned banks still provide undeveloped services.<sup>84</sup>

In 2005, the Central Bank of Libya (CBL) issued the new Banking Law No. 1, which exempts Libyan Commercial Banks (LCBs) and allows foreign banks to operate in Libya or invest in Libyan banks. Law No. 1 of 2005 also provides for the privatization and restructuring of state-owned banks. As a result of this law, two of the five state-

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<sup>81</sup> Central Bank of Libya 2006. „*Corporate Governance: Guideline for Board of Directors of Libyan Banks.*“ Central Bank of Libya.

<sup>82</sup> Otten, J. A., Heugens, P. P. M. A. R., & Schenk, E. J. J. (2006). Corporate governance reforms and firm ownership around the world. *Discussion Paper Series/Tjalling C. Koopmans Research Institute*, 6(01).

<sup>83</sup> Zagoub, A. A. (2011). *Corporate governance in Libyan commercial banks* (Doctoral dissertation, University of Dundee). P. 27.

<sup>84</sup> Zagoub, op. cit., P. 28.

owned Commercial banks (Sahara Bank and Al Wahda Bank) were privatized for foreign partners, BNP Paribas, and Arab Bank, respectively. Each bank owns 19% of the bank's share with the management's control with the option of raising their shares to 51% reform and benchmarks goals within three to five years. According to CBL (2010), the medium-term privatization strategy aims to phase out its holdings from the three commercial banks (Jumhouria Bank, National Commercial Bank and North Africa Bank). In 2008, most of the regional banks were merged into the North African Bank. Although the new banking law allows foreign banks to operate in Libya and several foreign banks have been granted licenses, they still face some restrictions to work in Libya.<sup>85</sup>

On the second anniversary of the 17 February 2012 Revolution, the National Congress adopted Law No. 1 of 2013 on the prohibition of interest in Financing transactions as one of the priorities to resume private economic initiatives in Libya and to reconcile the country. The banking sector in Libya consists of the CBL, seventeen commercial banks and four specialized banks (see Figure 2.2).<sup>86</sup>

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<sup>85</sup> Otten, Heugens, Schenk, op. cit.

<sup>86</sup> Central Bank of Libya (CBL), 2016. Development of the most important financial data and indicators for Libyan commercial banks (2008 - 2nd quarter). Tripoli, Libya

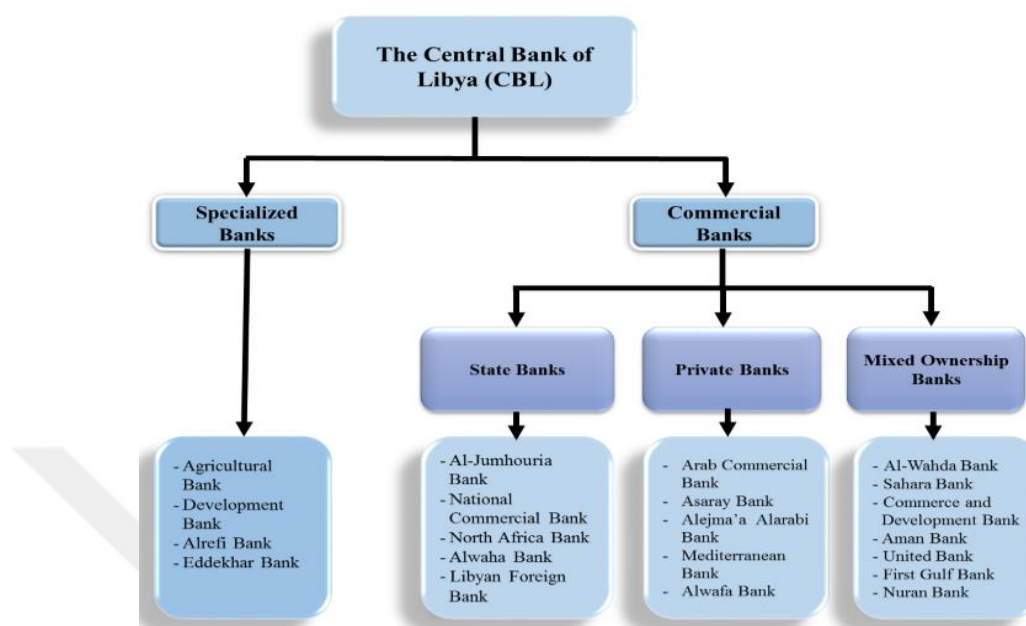


**Figure 2.1 the Libyan Banking Sector**

**Source:** Central Bank of Libya (CBL) (2016)

### 2.3. Central Bank of Libya (CBL)

The CBL was founded in 1956. It is the supreme monetary authority in Libya. An independent financial institution, wholly owned by the Government. Government laws define the purposes of the CBL in order to maintain monetary stability and facilitate national economic growth. The role of the CBL is to regulate and supervise the implementation of the credit and banking policy within the framework of the government's policy. The institutional reform program has supported the transformation of Libya; its core is the development and restructuring of the banking sector. Since the promulgation of Law No. 1 in 2005, the Central Bank of Libya has been gradually liberalizing the entire banking system with a view to restructuring and modernizing commercial banks. In pursuit of the CBL strategy to develop the Libyan banking sector and improve its regional and international competitiveness and attract

more foreign investment, the Libyan market has been gradually opened up to foreign banks.<sup>87</sup> The CBL functions can be summarized as follows:<sup>88</sup>

- ✓ Regulation and issuance of paper and metal currency.
- ✓ To maintain the stability of the Libyan currency inside and abroad.
- ✓ Manage state reserves of gold and foreign currencies.
- ✓ Organize bank credit in terms of size, type, and price, in order to meet the real needs of economic growth and monetary stability.
- ✓ Take measures to address international or domestic economic or financial turmoil.
- ✓ To work like a bank for commercial banks.
- ✓ To monitor commercial banks and to ensure the safety of their financial conditions and monitor the efficiency of their performance and ensure the rights of their customers.
- ✓ Work as a bank and financial agent for the state and its public institutions.
- ✓ Provide advice to the State regarding the drawing up and evaluation of economic and financial policy.
- ✓ Foreign Exchange Control.
- ✓ Perform the functions or operations normally performed by any other central bank and the functions assigned to it under the Banking Law or any international agreements to which the State is a party.
- ✓ Issue and manage loans held by the State.

### **2.3.1. Basel Committees on Banking Supervision and CBL**

The Basel Committee was established by the central bank Governors of the Group of Ten countries (the world's largest national financial systems) at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets.<sup>89</sup> The

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<sup>87</sup> Central Bank of Libya (CBL), 2010a. Code of Corporate Governance for Libyan Banks. Tripoli, Libya.

<sup>88</sup> Central Bank of Libya (CBL). [Online]. Available from: <https://cbl.gov.ly/en/history/>. Accessed on 13 May 2018].

<sup>89</sup> Bank for International Settlement. [Online]. Available from: <https://www.bis.org/bcbs/history.htm>. Accessed on 18 April 2019].

governors of the central banks of these member countries have intensified their efforts to develop mechanisms for the exchange of information, the identification of supervisory responsibility and the establishment of general standards. Since its establishment, the committee has aimed at strengthening the ability of national authorities to supervise the activities of their banks at the internal and international levels, as well as narrowing the gaps related to international banking supervision gradually until they are closed.<sup>90</sup> No formal supervisory authority was granted to the committee; hence, no established discounts have been able to obtain legal support. According to Wood, the Basel Committee has radically changed the international financial system since the mid-1970s, but its success has been limited.<sup>91</sup> In 2006, the Central Bank of Libya imposed on all banks an increase in its capital to 33333000 Libyan Dinars in order to be able to apply the Basel II standards as appropriate. Accordingly, the General People's Congress in Libya allocated the exchange rate to the banks, with 1 LD equal to US\$3.33.<sup>92</sup> The decision was a facilitative step for Libyan banks to raise the required capital. Some bankers state that, there are still difficulties in terms of the difficult situation of the Libyan market, in addition to the weak purchasing power of the people.<sup>93</sup>

In addition, many Libyan bankers consider that the actions taken by the CBL to rebuild and develop the banking sector, in accordance with Basel Committee standards, are unclear and largely ambiguous. Thus, there is still a clear distinction between reality and purpose. In this regard, it should be noted that some bank staff is still not familiar with Basel Committee rules and standards, which may reflect the fact that CBL has not done much to explain the rules of the Basel Committee or its role in the banking sector. On the other hand, CBL may not be serious in applying Basel Committee rules.<sup>94</sup>

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<sup>90</sup> Ibid.

<sup>91</sup> Wood, D., & Wood, D. R. (2005). *Governing global banking: the Basel Committee and the politics of financial globalisation*. Gower Publishing, Ltd, p. 4.

<sup>92</sup> Central Bank of Libya. (2008) Fifty- Two Annual Report. <https://cbl.gov.ly/en/wp-content/uploads/sites/2/2016/03/Annual-Report2008.pdf>. Accessed on 10 April 2018].

<sup>93</sup> Elmadani, M. (2015). *The Study of Service Quality in Libyan Commercial Banks* (Doctoral dissertation, University of Huddersfield). P. 24.

<sup>94</sup> Ibid., P.24.

## **2.4. Libyan Commercial Banks**

The Law on Libyan Banks (2005) defines a Commercial Bank as "any company that normally accepts deposits in current demand accounts, term deposits, loan and credit facilities, and participates in other banking activities".

Commercial banks are the most important financial institutions in Libya in terms of the role, size, geographical spread and range of services provided to customers.<sup>95</sup> Over the past two decades, the Libyan Central Bank has implemented a series of reforms to allow the establishment of local private commercial banks and the opening of branches by foreign banks. The foreign partnership in the Libyan banking sector is primarily aimed at transferring knowledge and using it to support and develop banking services. Despite the small size of private banks, their performance is rapidly developing. Thus, the sector now consists of seventeen banks (five of which are targeted in this study) which are owned by the State or the private sector or are shared by some government institutions and local and foreign investors, including the Libyan Dinar Unit of the Libyan Bank. These banks operate through 523 branches and banking agencies (see Table 2.2). As of 2013, they had total assets of 98.4 billion Libyan Dinars.<sup>96</sup>

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<sup>95</sup> Masli, op. cit., P. 12.

<sup>96</sup> Central Bank of Libya (CBL), 2013. The 57th Report of the Central Bank of Libya, Tripoli, Libya.

**Table 2.1: Ownership Structure of Libya's Commercial Bank**

| No  | Bank                   | Ownership | Number of Branches | State Owned | Private | Mixed Ownership |                    |                   |
|-----|------------------------|-----------|--------------------|-------------|---------|-----------------|--------------------|-------------------|
|     |                        |           |                    |             |         | State Owned     | Domestic Investors | Foreign Investors |
| 1.  | Al-Jumhouria           | State     | 146                | 100%        |         |                 |                    |                   |
| 2.  | Sahara                 | Mixed     | 49                 |             |         | 55%             | 26%                | 19%               |
| 3.  | National Commercial    | State     | 68                 | 100%        |         |                 |                    |                   |
| 4.  | Al-Wahda               | Mixed     | 76                 |             |         | 81%             |                    | 19%               |
| 5.  | North Africa           | State     | 53                 | 100%        |         |                 |                    |                   |
| 6.  | Commerce & Development | Mixed     | 30                 |             |         |                 | 50%                | 50%               |
| 7.  | Alwaha                 | State     | 10                 | 100%        |         |                 |                    |                   |
| 8.  | Aman                   | Mixed     | 23                 |             |         |                 | 60%                | 40%               |
| 9.  | United                 | Mixed     | 12                 |             |         |                 | 60%                | 40%               |
| 10. | Arab Commercial        | Private   | 3                  |             | 100%    |                 |                    |                   |
| 11. | Asaray                 | Private   | 3                  |             | 100%    |                 |                    |                   |
| 12. | Alejma'a Alarabi       | Private   | 12                 |             | 100%    |                 |                    |                   |
| 13. | Mediterranean          | Private   | 4                  |             | 100%    |                 |                    |                   |
| 14. | Alwafa                 | Private   | 3                  |             | 100%    |                 |                    |                   |
| 15. | First Gulf             | Mixed     | 1                  |             |         | 50%             |                    | 50%               |
| 16. | Libyan Foreign         | State     | 1                  | 100%        |         |                 |                    |                   |
| 17. | Nuran Bank             | Mixed     | 1                  |             |         |                 | 50%                | 50%               |

**Source:** Central Bank of Libya (CBL) (2016)

## 2.5 The Most Important Libyan Commercial Banks

As mentioned above, there are 17 commercial banks in Libya, but in this study, I focused on only five of them. I chose these banks because they are the largest in terms of spread and size of capital and oldest exists. The following is a brief overview of the commercial banks in Libya that were targeted during this study.

### 2.5.1. Jumhouria Bank

Jomhouria Bank (JB) was established on November 13, 1970. Jumhouria Bank is the largest bank in Libya in terms of assets, revenues and deposits, with 146 branches providing banking services to customers throughout Libya. Jomhouria Bank is one of the top 10 commercial banks in North Africa. It was a completely state-owned bank. In 2008, Alumah Bank merged with Jumhouria Bank under the name of Jumhouria Bank as part of the strategy adopted by CBL to restructure and develop the Libyan banking sector and modernize banking services. The new bank emerged as an active entity at the beginning of the second quarter of 2008 with a budget of more than 8

billion dollars. All activities offered by Jumhouria Bank are subject to the provisions of the Commercial Law and the laws governing the operation and activities of commercial banks supervised by the CBL.<sup>97</sup>

The Bank is developing and training its employees to improve their performance and their ability to use modern technological developments to provide advanced and high-quality products that accelerate the procedures and transactions and keep abreast of the latest technologies. The main services provided by the Bank can be summarized as follows:<sup>98</sup>

1. Opening current accounts, savings accounts and time deposits.
2. Accepting all types of funding, open letters of credit and foreign documents and contribute to the strengthening of foreign trade operations.
3. Publishing local and foreign letters of guarantee and conducting internal and external transfers.
4. Publishing ATM cards, selling and buying currencies.
5. Providing loans, commercial real estate and credit facilities to all customers.
6. Contributing to the financing of investment projects and real estate.
7. Leasing of safes
8. Providing financial and technical advice.

### **2.5.2. National Commercial Bank**

The National Commercial Bank (NCB) is one of the largest banks operating in Libya. The bank was established under the provisions of Law No. 153 of 1970 with a capital of 500 Million LD. The National Commercial Bank is a Libyan financial company established to provide the best banking services to its customers and to contribute to the country's growth. The NCB has 64 branches dedicated to providing the best quality services to ensure success and excellence. In 2012, the bank's growth rate increased by 57% compared to previous years, indicating the improvement and quality of

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<sup>97</sup> Jumhouria Bank (JB) [Online]. Available from: <https://www.jbank.ly/en/about-us/>. Accessed on 01 April 2019].

<sup>98</sup> Hossen, G. K. E. (2014). *Consumer perceptions of the barriers to adoption of internet banking: a case study in Libya* (Doctoral dissertation, University of Southern Queensland). P. 39.

services provided. The bank has financed various projects to contribute to the development of the national economy. The bank also offers a series of new products such as ATM services, fast transfer services, mobile phone services, easy credit and credit cards as well as traditional commercial banking services.<sup>99</sup>

The NCB aims to build strong relationships with its customers, who will benefit from the quality of services and product offerings and increase the share of the bank's market share. The NCB plans to improve the profitability of assets through a combination of improved balance of assets and improved network coverage, which will be achieved by opening new branches. The Bank also plans to improve the organizational structure of operations and business activities effectively and exploit business opportunities to benefit from competitive advantages by focusing on six pillars: customer service, products, channels, operations credit, organisational structure, and Information Technology Infrastructure. The National Commercial Bank offers some Islamic products such as Murabaha financing, which has been approved as a substitute for the interest system. Murabaha is a non-interest-based financing process for various periods. This service enables the bank's customers to acquire a wide range of furniture, household items, computers and cars through Murabaha. In order to secure most of the customers' needs.<sup>100</sup>

### **2.5.3. Sahara Bank**

The Sahara Bank (SB) is one of the biggest Libyan commercial banks with capital of around 252 million Libyan Dinars and around 1,500 workers. The SB is a mixed ownership bank. The SB was established in 1964, and in 2007, the Bank entered into a strategic partnership with the National Bank of Paris Group (BNP) as the first Libyan bank to enter into a foreign partnership. This partnership resulted in the development of the Sahara Bank. The bank has benefited greatly from its foreign strategic partner because of its experience in this field. This partnership established the first foreign

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<sup>99</sup> Central Bank of Libya. (2008) Forty- Nine Annual Report.

<sup>100</sup> National Commercial Bank. [Online]. Available from: <https://www.ncb.ly/ar/about-us/our-history/>. Accessed on 01 April 2019].

bank to develop banking activities in Libya. BNP Paribas is expected to play a key role in the development of the Bank of Sahara to keep pace with the development and provide its services better.<sup>101</sup> According to Panorama reports in 2008, the SB acquired a market share of 22% of deposits with a growth of 25% in loans to take about 17% of the share of the loan market in Libya.<sup>102</sup>

#### **2.5.4. Wahda Bank (WB)**

WB was established by Law No. 153/1970, which provides for the merger of five banks into one, called Wahda Bank. These five banks are (Arab Bank, the Bank of North Africa, Khafila Bank, Alnahda bank, and Commercial Bank). The paid-up capital is 108 million Libyan Dinars distributed as follows: 54.1% of the shares to finance economic and social development, 26.9% of the shares to the private sector and 19% of the Bank's share capital to the strategic partner Arab Bank. The Bank offers a comprehensive range of products and services to meet customer requirements at 76 branches throughout the country.<sup>103</sup>

The bank is keen to train employees through training programs in Libya and abroad to ensure that banking operations reach international standards. The bank also uses modern technologies to better serve all banking operations in terms of international regulations, standards, and policies. The WB has a strategic vision based on its historical roots and financial reputation. It has improved efficiency in the service of the national economy and in response to global economic changes. The bank's executive management has taken several steps towards applying the latest modern automated systems to improve banking services in all aspects of the banking industry.<sup>104</sup>

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<sup>101</sup> Elmadani, M. (2015). *The Study of Service Quality in Libyan Commercial Banks* (Doctoral dissertation, University of Huddersfield). P. 30.

<sup>102</sup> Panorama Reports (2008) Modernizing the banking sector and investing globally, available at: <http://www.panoramareports-ltd.com/pdf/libya.pdf>. Accessed on 01 April 2019].

<sup>103</sup> Wahda Bank. [Online]. Available from <http://www.wahdabank.com.ly/en/index.php/aboutus/aboutus1>. Accessed on 01 April 2019].

<sup>104</sup> Hossen, op. cit., P. 40.

### **2.5.5. Bank of Commerce and Development (BCD)**

The BCD was founded under Law no. 1/ 1996, as a Libyan business entity. It is one of the most important members of the Union of Arab Banks, the Union of Maghreb Banks and the Association of Libyan Banks. In 2008, it was decided to raise the bank's capital to the value of 50 million LD by offering new shares in the market.<sup>105</sup> The fifth-largest Libyan bank operating in the country in terms of assets and deposits, and comes in sixth place in terms of loans. It currently has twenty-eight branches distributed in different parts of Libya. The bank is ranked as the fastest growing bank in Libya and uses modern technology to deliver its services to customers. The BCD was the first Libyan bank to offer online banking and capitalized on its IT infrastructure, allowing the bank to deploy a new unified service across its network quickly.<sup>106</sup>

## **2.6. The Islamic Banking System in Libya**

The main objective of Islamic law is to ensure the safety and justice of Muslims by protecting their religious and personal rights and the rights of wealth and property. With regard to financing, in particular, Shariah imposes special obligations on banks and other financial institutions, including prohibitions on charging interest and trading under uncertainty.<sup>107</sup> As a result, they have developed Shariah-compliant financial products and services to meet the needs of Muslim clients.<sup>108</sup> As the market evolves, Islamic financial services play an increasing role in the international economy. Currently, there are more than 600 Islamic banks and more than 700 Islamic investment funds spread around the world with assets of up to 2 trillion dollars. In

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<sup>105</sup> Magrus, A. A. A. (2012). *Corporate Governance Practices in Developing Countries: The Case of Libya* (Doctoral dissertation, University of Gloucestershire). P. 14.

<sup>106</sup> Elfaituri, A. A. (2012). *An assessment of TQM implementation, and the influence of organisational culture on TQM implementation in Libyan banks* (Doctoral dissertation, University of Gloucestershire). P. 24.

<sup>107</sup> Ökte, M. (2010). FUNDAMENTALS OF ISLAMIC ECONOMY AND FINANCE: THEORY AND PRACTICE. *Electronic Journal of Social Sciences*, 9(31). P. 181-185.

<sup>108</sup> Grais, W., & Pellegrini, M. (2006). *Corporate governance and Shariah compliance in institutions offering Islamic financial services*. The World Bank.

addition, many non-Muslims now use products offered by Islamic financial institutions and Islamic windows in traditional banks.<sup>109</sup>

The actual transformation toward Islamic banking in Libya began with Libyan Banking Law No. 1/2005, which allowed some banks to establish some Islamic banking services and products as a category of licensed activities.<sup>110</sup> Jumhouria bank was the first bank to start offering Islamic products by opening Islamic banking windows. But before 2011, the Libyan government did not show much support for Islamic banking. After the revolution of 2011, the National Transitional Council issued Law No. 46/2012, which amended the banking Law No. 1/2005 to include a detailed chapter on Islamic banking and the establishment of Islamic banks.<sup>111</sup>

In 2013, the CBL promulgated Law No. 1/2013, which prohibits all interest charges (RIBA).<sup>112</sup> With the introduction of this law, it became easier for banks to switch to Islamic banking and encouraged investors to open new Islamic banks. The Central Bank of Libya (CBL) has begun the process of transforming the traditional banking system into an Islamic banking system, setting up Sharia committees and opening windows within existing and new banks to provide specialized Islamic banking services, mainly Murabaha and Musharaka financial products. However, many banks are still in the early stages of transition due to a lack of experience in Islamic banking, inadequate training of staff, lack of an Islamic financial market in Libya, unstable political and economic situation and other reasons.<sup>113</sup> Despite these challenges, Baej and Worthington are optimistic that the transition process will eventually be completed after the CBL, regulators, banks, academics, and society as a whole support it.<sup>114</sup>

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<sup>109</sup> Masiukiewicz, P. (2014). Multicultural issues in the development of Islamic banking. *Journal of Intercultural Management*, 6(3), 167-176. P. 167.

<sup>110</sup> Shalba, A. (2016). *An investigation of the roles and responsibilities of the board of directors in the Libyan banking sector* (Doctoral dissertation, Nottingham Trent University). P. 17.

<sup>111</sup> Baej, Y. M., Worthington, A. C., & Worthington, A. (2014). Prospects, barriers, and impediments to Islamic banking in Libya'in. *Contemporary Issues in Islamic Finance: Principles, Progress, and Prospects*, Nova, New York, NY, 109-116.

<sup>112</sup> Stela, A. K., & Abdulsalam, A. A. (2016). The citizens satisfaction level on the Islamic banking system of Libya. *IOSR Journal of Economics and Finance*, 7(6), 12-22.

<sup>113</sup> Elkrghli, S., & Yahya, A. (2018). Bankers' Views Towards Islamic Banking and Islamic Marketing: The Case of Libyan Main Wahda Bank in Benghazi City. *Management*, 6(1), 37-55.

<sup>114</sup> Baej, Worthington, op. cit., pp. 109-116.

Under Decree No. 9/2010 and Article 100 of Law No. 47/2012, Islamic banks must appoint a Shari'a Supervisory Board of at least three Shari'a and Islamic banking experts appointed and rewarded by the Board of Directors and require integrity, honesty and knowledge of the Qur'an and Sunnah.<sup>115</sup>

## **2.7. Obstacles Faced by the Libyan Banking Sector**

Although Libyan banks offer an increasing range of services and play an increasingly important role in the economy, the Financial Development Index 2002/2003 shows that Libyan banks recorded the lowest scores among the MENA countries at 1.3 (the average score is 5.5).<sup>116</sup> The Libyan banking sector is still lagging behind banks elsewhere in the Middle East. This is a matter of concern as unstable banking performance and unstable banking activity can slow economic growth. Therefore, experts call for the reform of the banking market as part of a broader strategy to improve the Libyan economy and to recognize that the efficiency of the banking sector is closely linked to the effectiveness of the Libyan economy as a whole.<sup>117</sup>

Government intervention hampers the activity of companies in public companies, where the Libyan government controls, directly or indirectly, the majority of assets and institutions in Libya through a wide range of industries, financial institutions and real estate.<sup>118</sup>

The former regime had strict control over the banking market, especially lending activities. This caused problems in terms of bank operations and the setting of targets. Libyan banks have provided loans in accordance with the guidelines set by the system recklessly, such as failed corporate loans, for they are confident that the government will intervene and provide appropriate support in times of distress. This, in turn, has

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<sup>115</sup> Grassa, R. (2015). Shariah supervisory systems in Islamic finance institutions across the OIC member countries: An investigation of regulatory frameworks. *Journal of Financial Regulation and Compliance*, 23(2), 135-160.

<sup>116</sup> Saidi, N. A. H. (2005). *Corporate Governance in the Arab Countries: Role of Banking System in Ensuring Transparency & Disclosure*. N. Saidi.

<sup>117</sup> Shalba, op. cit., pp. 30-31.

<sup>118</sup> Porter, M. and Yergin, D. (eds.), 2006. National economic strategy: an assessment of the competitiveness of the Libyan Arab Jamahiriya. Tripoli: General Planning Council of Libya.

led to the lack of autonomy of the managers and to more risk and non-traditional banking activity.<sup>119</sup>

The function of the Central Bank of Libya (CBL) since its establishment in 1956 is to supervise and regulate the banking sector in the country. To maintain the strength of the sector, the Central Bank of Libya has introduced new regulations and has responded to many problems and crises in the industry over the years. For example, the CBL intervened and approved Resolution No. 58/2006 to merge 41 regional banks into the National Banking Corporation when regional banks were established in 2000 and 2001 and faced serious liquidity problems from the beginning. By the end of 2004, the board members of these banks were borrowing heavily from banks and defaulting, resulting in significant problems with inappropriate loans and mismanagement. The CBL had to intervene in individual banks. In 2006-07, for example, when Al-hliah Tagowrah Bank faced financial difficulties, the Central Bank of Libya stopped its operations. In the mid-2006, most of the members of the Board of Directors received huge loans from the bank, the bank referred the case to the Minister of Finance who sent it to the Council of Ministers. The chairman refused to resign, so he was expelled by the finance minister. Now, the trusteeship council appointed by the Minister of Finance and the CBL direct the bank.<sup>120</sup>

Moreover, stated in some studies, the absence of laws and regulations that regulate the profession of accounting and auditing in Libya and their inconsistency in the application of accepted professional standards is another obstacle to the development of the Libyan banking sector. As indicated by the World Economic Forum,<sup>121</sup> "*Libya was the best macroeconomic condition (in 2010) of the local normal, reflecting essentially the record of fundamental monetary surpluses and low obligation.*" However, Libya ranks better than the international average only on political stability.

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<sup>119</sup> Shalba, op. cit., p. 31.

<sup>120</sup> Central Bank of Libya, 2012. The seventy-one report of the Central Bank of Libya. Tripoli: Central Bank of Libya.

<sup>121</sup> Al-Darwish, A., Cevik, S., Chami, R., Charap, J., George, S., Gracia, B., ... & Pattanayak, S. (2012). Libya beyond the Revolution: Challenges and Opportunities. P. 17.

## **CHAPTER THREE**

### **Factors Affecting the Internal Audit Quality: Empirical Evidence from Libyan Commercial Banks**

Chapter three introduces the study and highlighted the problem statement and objectives and the hypotheses of this study. In addition, the chapter discusses the research methodology and methods that are adopted in this study, presents the results from the data collection and analyses these results.

#### **3.1. Importance of the Study**

Despite the importance of the role played by the IA function in any establishment, there were no previous scientific researches dealing with the quality of internal auditing in Libyan commercial banks in particular within the scope of the researcher's information. However, most studies focused on the internal control system, which encouraged the researcher to conduct this study to explore the factors affecting internal audit quality, has been focused on the internal auditor Employees of commercial banks, in particular, have access to more accurate results. The importance of this study stems from the importance of the internal auditing function itself because it is considered one of the most important pillars of banking governance. The interest in the IAQ leads in turn to increase the efficiency of the supervision and its regulation, which helps to improve the performance of the banking administration.

#### **3.2. Literature Review**

The function of IA has become one of the most important departments in all economic institutions as one of the main management mechanisms and this role has evolved over time.

The study of the Matarneh (2011) aimed to study the relationship between efficiency, objectivity, and performance of internal auditors and Internal Audit Quality in Jordanian banks. The researcher designed a questionnaire and used to achieve the purpose of the study. The result of the research found that the IAs working in Jordanian

commercial banks classify the efficiency, performance, and objectivity of the IAs as important factors affecting the quality of the IA. At the end of the study, the researcher recommended commercial banks operating in Jordan to ensure that there are basic factors to achieve the IAQ function.<sup>122</sup>

The study of Ashour, M. S. R., Sukoharsono, E. G., & Ghofar, A. (2015). The purpose of the research was to study and test the impact of IA team competencies, the interaction between IAs and audit committees, and risk management on the effectiveness of IA in LCBs. To achieve the objective of the study, the researcher used the quantitative approach of analysis. The study sample consists of 105 internal auditors randomly selected from LCBs. The researcher used the descriptive approach using surveying from commercial banks, analyzing the impact of competencies, and managing auditors on the effectiveness of the IA. The results were as follows: 1. The internal audit team's competencies on the effectiveness of IA were important and complete. 2. Risk management has been the most important and positive link to the effectiveness of the internal audit. 3. The interaction between IA and Audit Committee oversight on the effectiveness of the IA was important and positive. The researcher recommended that: 1. update the system to be similar to the developed countries if possible to be more effective. 2. Give more support to the IAS so that the Libyan commercial banks could be able to sustain and raise the quality of Risk management. 3. Recommended more surveillance for the system of Libyan commercial banks.<sup>123</sup>

Elnafabi study (2017) aims to identify the quality of internal auditing in Sudanese commercial banks and the factors affecting quality. A questionnaire was designed and distributed to the internal auditors of the Sudanese commercial banks. The main findings of the researcher are the existence of some factors that negatively affect the quality of the internal audit in the Sudanese banks, such as failure to obtain any professional qualification for a large segment of internal auditors. Lack of adequate training, management intervention in the development of audit plan, general manager

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<sup>122</sup> Al Matarneh, G. F. (2011). Factors determining the internal audit quality in banks: Empirical Evidence from Jordan. *International Research Journal of Finance and Economics*, 73, 99-108.

<sup>123</sup> Ashour, M. S. R., Sukoharsono, E. G., & Ghofar, A. (2015). The Impact of Competencies, Risk Management and Auditors Interactions on Internal Audit Effectiveness in Libyan Commercial Banks. *The International Journal of Accounting and Business Society*, 23(1), 1-20.

to manage the dependency of the IAD rather than the Board of Director or the Audit Committee. On the other hand, this study indicates that there are some factors support the quality of internal auditing such as: that senior management supports the internal audit department, and IA recommendations always or often are implemented and that most banks maintain audit committees. The main recommendations of the researcher: one- to verify the effectiveness of the internal control system and the continuous pursuit of the development of this system. Two- The Internal Audit Sections of the Board of Directors should be followed fully independent. Three- The minimum academic qualification for appointment of internal auditors shall be a certificate Bachelor of Accounting. Four- Care must be taken to rehabilitate the internal auditors for professional certification. Five- The administration does not interfere in the planning and work of the internal audit departments.<sup>124</sup>

Alzeban, A., & Gwilliam, D. (2014). The study provides proof on the style during which competency, the size of the internal audit department, the communication between the internal and external auditors, the independence of the internal audit, and the extent of administrative support for the internal audit operations contribute to raising the effectiveness of internal audit departments operating within the Saudi public sector. The main findings of the researcher are that the management's support for internal auditing increases its effectiveness and reduces risks.<sup>125</sup>

Deribe, W. J., & Regasa, D. G. (2014), aimed at analyzing factors affecting the IAQ in Ethiopian Commercial Banks. The researcher used quantitative research techniques to reach the aim of the study. The most important results reached by the researcher are; 1 - The most important factor affecting the IAQ in Ethiopian commercial banks is the performance of the internal auditors. 2. The efficiency factor is the second most important factor affecting the IAQ in Ethiopian commercial banks. 3. The use of information technology in the audit process ranked third in terms of its impact on the quality of internal audit in Ethiopian commercial banks. 4 - Which surprised the

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<sup>124</sup> Elnafabi. (2017). Quality of Internal Auditing in Commercial Banks in the Sudan and Its Influencing Factors from the Perspective of Internal Auditors: An Analytical Study .*Amarabac Magazin*. ٣١-١ ، (٨٠) ٣٩٤

<sup>125</sup> Alzeban, A., & Gwilliam, D. (2014). Factors affecting the internal audit effectiveness: A survey of the Saudi public sector. *Journal of International Accounting, Auditing and Taxation*, 23(2), 74-86.

researcher that the study found that the objectivity of internal auditors is not one of the factors that affect the IAQ in Ethiopian commercial banks. The researcher recommended that commercial banks operating in Ethiopia use the results of the study to determine the IAQ.<sup>126</sup>

Al-Akra, M., Abdel-Qader, W., & Billah, M. (2016). The researchers aimed to review the Middle East and North Africa (MENA) region literature relating to the internal audit function. Particularly, the research reevaluated studies related to the three areas that involve the definition of internal auditing. Despite reforms initiated by the countries of the region, this study showed that the independence and objectivity of internal auditors lacked current reform. The studies also show that the role of the internal auditor in the region focuses primarily on verifying the reliability of financial reporting, complying with rules and regulations, evaluating internal controls and focusing less on value-adding activities. Studies have shown that the role of IA in the provision of advisory services has often been in risk management, control, and governance. These results were largely influenced by the influence of cultural factors on IA professionalism, standardization of practice, and independence due to the collective nature of the Middle East and North Africa communities where family and tribal considerations take precedence. This community impact reduces administrative support to IA departments, impeding IA independence, reducing budget allocations to IA, and ultimately reducing IA training, skills, and knowledge. The researcher hopes that this study will also contribute to stimulating further research in the Middle East and North Africa.<sup>127</sup>

Prawitt, D. F., Smith, J. L., & Wood, D. A. (2009). In this study, the researchers used a unique and previously unavailable data set, looking at the relationship between the IAF quality and profit management. It measures the quality of the IAF using a composite measure consisting of six individual IAF quality components based on SAS

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<sup>126</sup> Deribe, W. J., & Regasa, D. G. (2014). Factors determining internal audit quality: Empirical evidence from Ethiopian commercial banks. *Research Journal of Finance and Accounting*, 5(23), 86-94.

<sup>127</sup> Al-Akra, M., Abdel-Qader, W., & Billah, M. (2016). Internal auditing in the Middle East and North Africa: A literature review. *Journal of International Accounting, Auditing and Taxation*, 26, 13-27.

No. 65, which guide external auditors in assessing the quality of IAF in relation to their role in financial reporting. Profit management is measured using two separate agents: (1) abnormal receivables and (2) tendency to meet or exceed analyst expectations. They found evidence that the quality of the IAF was associated with a moderate level of earning management as measured by both agents. The researchers recommended that companies and their audit committees examine the quality of the IAF as defined in the external audit standards and explore ways to improve the function in light of the results of their studies. It was suggested that the authors of the IA standards could identify these findings in their deliberations on the potential role of internal audit in influencing externally reported financial figures. They also recommended that the Securities and Exchange Commission, Stock Exchange Management and other groups concerned with corporate governance processes consider this role more clearly.<sup>128</sup>

Alaswad, S. A. M., & Stanišić, M. (2016). The research paper aimed to analyze the impact of internal auditing on the performance of financial institutions in Libya. The researcher collected data from 26 financial companies listed on the Libya Stock Exchange. The four IA characteristics are the size of the audit committee, the independence of the audit committee, the auditor's qualification, and the auditor's experience as independent variables while Return of Assets is used as a variable to measure the variable's performance. Data has been retrieved off the financial reports of the Organization for the triennium 2013, 2014 and 2105. Link and regression tests were performed using the SPSS program. The study found that the relationship between the size of the Internal Audit Committee and the performance is not statistically significant while there are other variables significant in the performance of these organizations. Based on the experimental results of the study recommended the researcher to tighten the weak areas identified in this study.<sup>129</sup>

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<sup>128</sup> Prawitt, D. F., Smith, J. L., & Wood, D. A. (2009). Internal audit quality and earnings management. *The accounting review*, 84(4), 1255-1280.

<sup>129</sup> Alaswad, S. A. M., & Stanišić, M. (2016). Role of internal audit in performance of Libyan financial organizations. *International Journal of Applied Research*, 2(2), 352-356.

### **3.3. Objective of the Study**

Since the revolution of February 2011 in Libya, the economic institution has faced several problems that hampered its natural growth and continue its activities due to political instability and the division of the country to the east and west. The proliferation of weapons, which led to the weakness of the supervisory bodies in the state and thus to the spread of financial corruption in all state institutions.

The Central Bank of Libya plays the role of supervising commercial banks through the department of supervision of banks and cash. According to the Libyan Audit Bureau 2011-2016, the weakness of the department of supervision of banks and cash led to the loss of control of the Libyan Central Bank on commercial banks and the inability to oblige them to implement the instructions or implement the controls and demands contained in the letters of the Central Bank. The shortcomings in the supervision of commercial banks resulted in frequent violations and irregularities and the spread of the phenomenon of theft, embezzlement, and manipulation of many banks. In a state like Libya, there are many challenges to be tackled for ensuring a seamless auditing process. So-to-say, the parameters that associate with auditing outcomes and critical to the auditing quality are required to be monitored by the audit controllers.

In order to establish a strong base for an audit, it is necessary to understand the feedbacks of audit officials. Therefore, we may put on some points as in (Appendix 1) and address out the importance of those points by broadcasting it among internal auditors. To achieve the objective of the study the research questions and hypotheses are explained below:

What factors affect the quality of internal audit quality in LCB?

The following questions stem from it:

- 1- Does the independence of the Internal Auditors of LCB affect the IAQ?
- 2- Do the training courses received by the Internal Auditors affect the IAQ of LCB?
- 3- Does the Board of Directors' support for the IAD affect the IAQ of LCB?

4- Does the size of the IAD affect the IAQ of LCB?

5- Does the level of experience of the Internal Auditors affect the IAQ of LCB?

To answer these questions, the following hypotheses were developed:

**H1-** The independence of the IAs affects the IAQ of the LCB.

**H2-** The training courses received by the Internal Auditors affect the IAQ of the LCB.

**H3-** The Board of Directors' support for the department of IA affects IAQ of LCB.

**H4-** The size of the IAD affects the IAQ of the LCB.

**H5-** The level of experience of the Internal Auditors affects the IAQ of the LCB.

The researcher expects to face some difficulties regarding provide the information required for the purpose of research due to the sensitivity of the subject matter of the study in practice, which may raise some reservations and doubts by the workers.

### **3.4. Methodology**

In order to achieve the objective of this study and to test its hypotheses, the researcher intends to adopt the analytical descriptive method to examine the factors affecting the IAQ of the Libyan banks, based on two main types of data: secondary data and preliminary data:

Dependence on secondary data in determining the theoretical framework of the study through previous studies, unpublished studies, periodicals and books, review of accounting and financial literature on the subject of IA in banks, in addition to the professional performance standards issued by the American Institute of Internal Auditing in 1978 and the decisions of the Basel Committee. In order to review the procedures applied in the IA departments of the Libyan commercial banks.

The preliminary data for this study was collected through a questionnaire designed for this purpose and distributed to the study community composed of the internal auditors of the LCBs. The researcher used appropriate statistical methods for analyzing the data using the Matlab program for statistical analysis.

In this chapter, the researcher is going to enlist the parameters that affect audit quality and performance. This is however performed by conducting a survey-based study and processing survey information in Matlab software. The survey is initiated using a set of questions as in Appendix (I), thirty-five questions are published in thirty of survey candidates in such way each candidate (out of thirty) will be able to answer all thirty-five questions. Candidates are selected accurately so that resultant data can rely on further analysis. The researcher has targeted those communities who are related to Internal Audit Departments in LCBs and questions are made in the form of excel sheet and distributed to some candidates by email and others by hand delivery. The preparation of survey questions is made so that first six questions are designed to gather the identification details of the candidate such as gender, age group, educational level, and degree, professional degrees, exact educational field allotted to the candidate and finally exact experience-banking career. Furthermore, the coming twenty-nine questions are made to cover all essential parameters involved in auditing proficiency. Data are gathered from the candidates and prepared for further processing in Matlab environments. Preprocessing method is used to analysis the data in Matlab, Preprocessing method detailed in the coming sections of this chapter.

### **3.4.1. Survey Designing**

Thirty survey questionnaires are answered and collected so to say all thirty candidates responded and found no problem with their answers such as null answers or unanswered questions. Questions of the survey are made in two categories more likely, to understand the identity of responders and to explore the responder's opinion about the survey questions. The Questions here are made based on the parameters that are impacting the performance of auditing. The questions are designed after considering the following points (keywords):

1. Internal audit department.
2. Internal auditors.
3. Internal audit department head (chairman).

4. The organization that held the audit process (beneficiaries alike banks and companies).
5. Audit department, which by the most refer to the audit company or national auditor that works for the government and aims to control the business conducted under the companies (private and national).
6. Decision of auditor to be free and no impact of other authorities in this decision.
7. Recommendations, which means the instructions that made by the auditor and handed to the company (e.g. banks) to be followed in the current or next financial year.
8. Interests which means the point of views of the audit department and point of view of the company, which supposed to be approaching, and made with no conflict.
9. Access, which means the reachability of the required records (data) and/or required entities such as authorized people alike managers and extra. The same is expected to be free as auditors can access those resources whenever it is required.
10. Dependency, which related to the responsibility of the auditors that required to be independent of other responsibilities.
11. Interference which refers to the outsider (not a member in the internal audit department), those kinds of people are supposed not to affect the decision of auditors.
12. Reports are referred to the outcomes of the audit process that made by the auditor after ending the process and coming into conclusions.
13. The internal audit department, which is part of the company that has been undergoing the audit process, can discuss technically the report of the external auditor (public auditor) where both parties can be and clarify the points of conflicts.
14. Power, which refers to the IAD and allotted to it by the directors' board of the company or bank.
15. Training which refers to train the auditor of the particular company (bank) to achieve the expected performance of their work.
16. Academic qualifications which are related to the level of academic education that auditor received.

17. Professional qualification, which refers to the professional certificate, received by the entity (person) such as chartered accountant (CA) and extra.
18. Human resources which stands for the manpower that participate the process of auditing with different levels of responsibility.
19. Financial resources which means to finance the auditor (department) with enough funding to fulfill audit requirements.
20. Senior manager is defined to be the head of the company (bank) or the company chairman.
21. Size refers to the number of the members constructing the audit department.
22. Duration, which means the time taken by the auditors to complete the audit tasks.

Questions of this survey are implemented on the following bases Figure 3.1:

1. Identifying who is the responder;
2. Highlighting the effects of the parameters related to audit department responsibilities;
3. Highlighting of bank manager (company head) responsibilities;

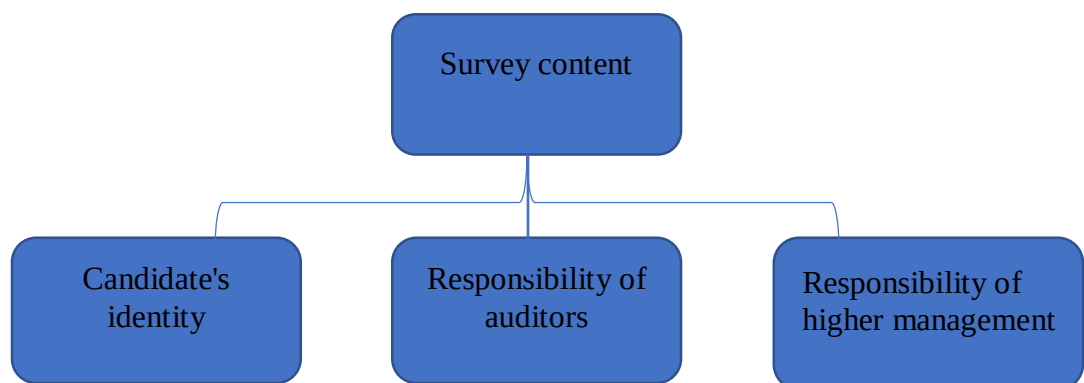


**Figure 3.1: Survey directions and contains**

### 3.5. Results

#### 3.5.1. Descriptive Statistics

After receiving the responses from all candidates in the survey, the Excel sheet included all information is fed into Matlab where it can be analysed. For an instant, the researcher realized that the number of male candidates is quite more than the number of female candidates. Figure 3.2 demonstrates the difference between male and female candidates participating in this survey. The total number of candidates in this survey is 30 where 27 candidates are males and rest 3 are females. The variance between the numbers is due to the nature of the profession where males in the country of Libya dominate such a career.

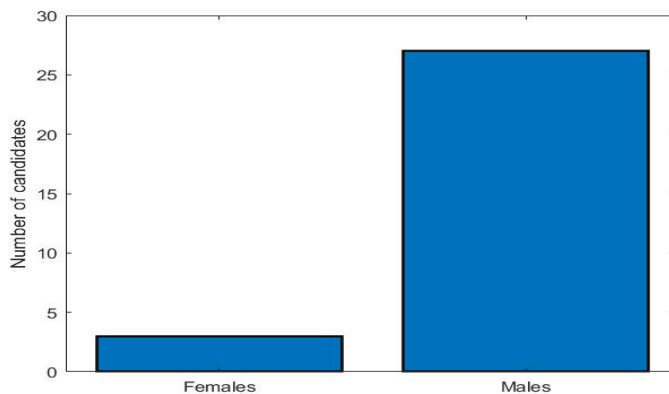


**Figure 3.2: Difference between the male and female candidates participating the survey.**

Coming to the next point of interest, the age of candidates is also inquired; the researcher made the following options, which each candidate, which is reflecting his/her, age group, must elect one of it. Table 3.1 is detailing the age categories, which the researcher covered in the survey.

**Table 3.1: Age groups of the candidates participated the survey**

| Category           | Number of candidates |
|--------------------|----------------------|
| Less than 25 years | 1                    |
| 26 to34 years      | 8                    |
| 35 to 44 years     | 10                   |
| Above 45 years     | 11                   |
| <b>Total:</b>      | <b>30</b>            |

The same information is plotted in the Figure 3.3.

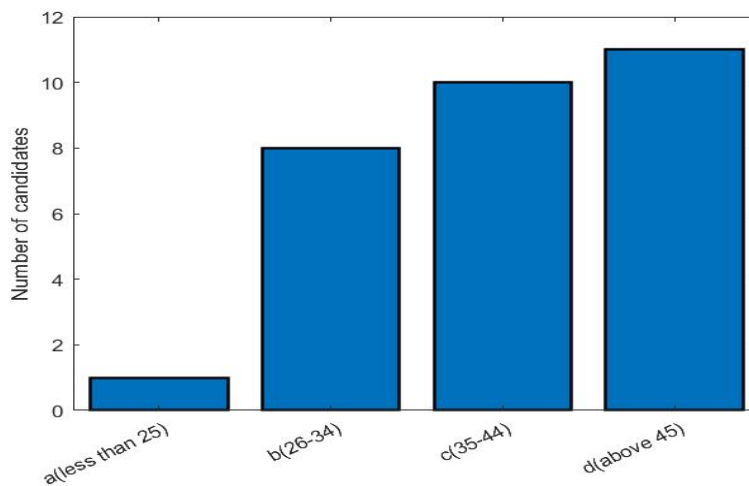


**Figure 3.3: Age groups of the candidates participated the survey**

Figure 3.3 shows that the top population of candidates lies on those who are above 45 where they are more experienced in the purpose of this study. Similarly, the next large population is 35 to 44 years old and only one is less than 25-year-old as only one junior. It is clear that most of the candidates who participate in the survey have professional experience. This is a good advantage in order to meet the study objectives.

From the other hand, the academic qualifications of the candidates are also inquired as follows:

**Table 3.2: Academic qualification of the candidates**

| Degree                   | Number of candidates |
|--------------------------|----------------------|
| Diploma*                 | 9                    |
| Bachelor of science BSc. | 18                   |
| Master degree            | 3                    |
| <b>Total:</b>            | <b>30</b>            |

***\*Diploma meaning:** After a high school, the student has two options: either to study three years in the higher institute and get a diploma degree. Or, he can study for four years and get a bachelor degree.*

The table reveals that largest number of candidates are received bachelor degree and post-graduation (master degree) and only nine of all are having diploma degree. The same is demonstrated by the following Figure.

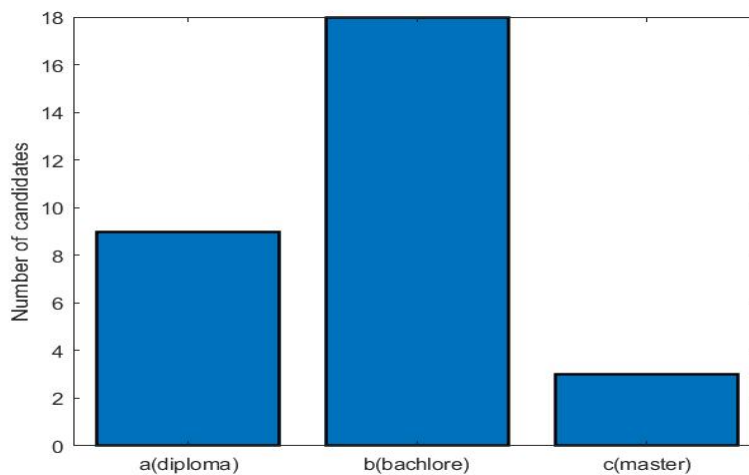


**Figure 3.4: The academic qualification of the candidates**

In the same point, we can list the specialization of candidates in the table below:

**Table 3.3: Educational field of the candidates**

| <b>Educational field</b> | <b>Number of candidates</b> |
|--------------------------|-----------------------------|
| Banking                  | 6                           |
| Accounting               | 16                          |
| Statistics               | 1                           |
| Management               | 6                           |
| Computer                 | 1                           |
| <b>Total</b>             | <b>30</b>                   |

The topmost people of accountant specialization and then from banking sciences. Furthermore, the extra courses, which considered as provisional certificate such as CA, CIA and extra, also monitored in the candidates and the results are plotted in Figures 3.5 and 3.6.

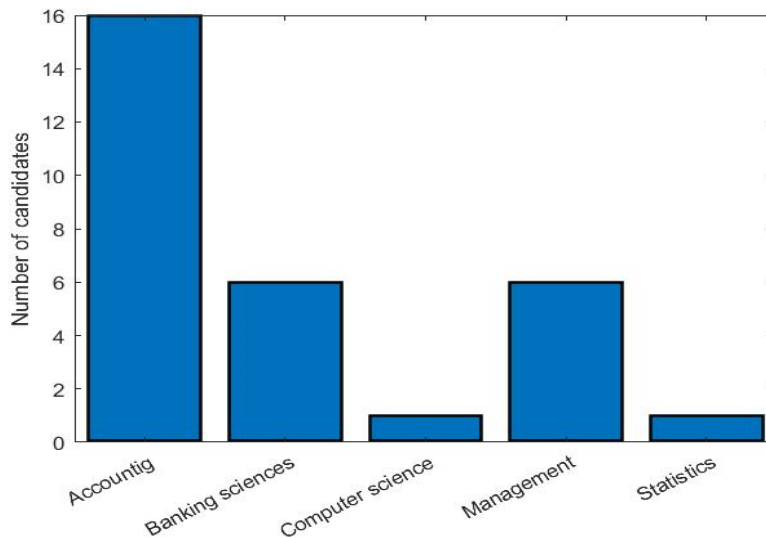


**Figure 3.5: Educational specialization of the candidates with light of Table 3.3**

Table 3.4, is detailing the number of candidates that holding a professional certificate, data reveals that only four of the candidates are a holding finance relevant degree otherwise, twenty-six of them are not holding any professional certificate.

**Table 3.4: Provisional certificate received by the candidates participating the survey**

| Provisional certificate                  | Number of candidates |
|------------------------------------------|----------------------|
| Certificate of Islamic Banking           | 1                    |
| CA, CIA and CPA                          | 3*                   |
| Do not have any professional certificate | 26                   |
| <b>Total</b>                             | <b>30</b>            |

\* One of each respectively.

The figure below is demonstrating the Table 3.4 for more clarification.

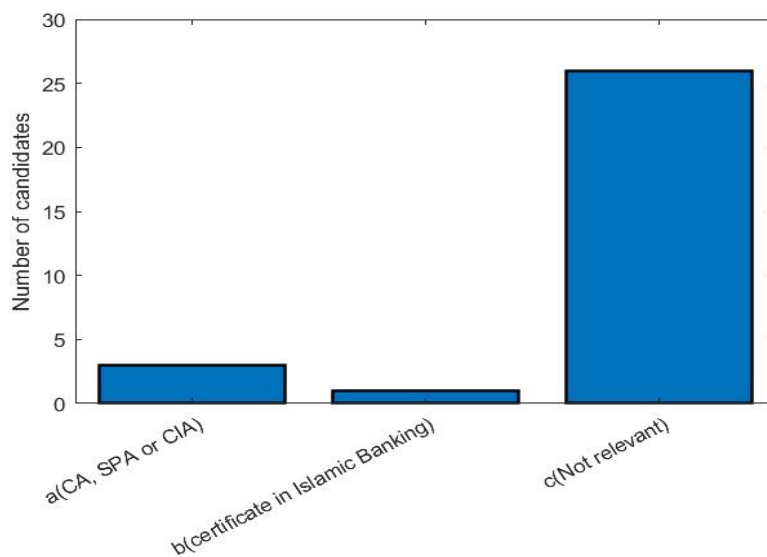


**Figure 3.6: Professional certificate received by the candidates with light to Table 3.4**

Lastly, the researcher set a question about the candidates' experience in a current career, similarly the researcher-initiated the survey on experience term by making the following Table, the candidates are distributed on the mentioned experience categories as stated in Table 3.5.

**Table 3.5: Experience slaps distribution in terms of number of candidates as per the survey results**

| Category                | Number of candidates |
|-------------------------|----------------------|
| More than fifteen years | 18                   |
| Ten to fifteen years    | 5                    |
| Five to ten years       | 3                    |
| Less than five years    | 4                    |
| <b>Total:</b>           | <b>30</b>            |

With the light of Table 3.5, following Figure can be plotted; Figure 3.7 declared that senior candidate's population is more.

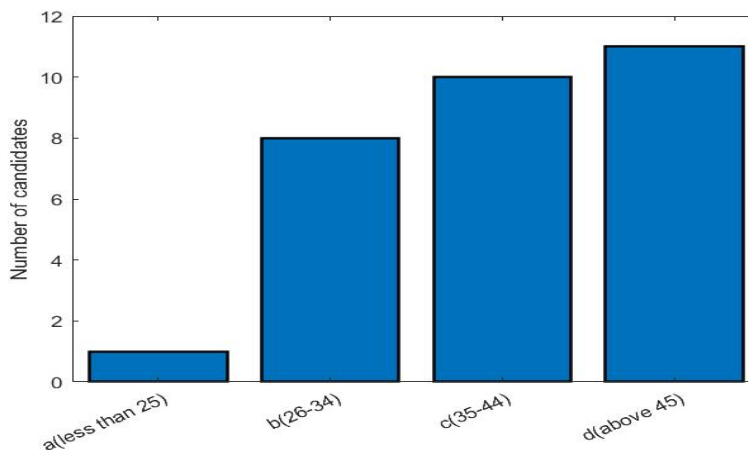


**Figure 3.7: experience of responders**

### 3.5.2. Preprocessing Method

As discussed in preceding sections, data is acquired from the participants by means of distribution of emails and hand delivery holding the checklist of questions; thirty-five questions are distributed to grape the information from the candidates. First six questions are made to get the knowledge regarding the candidates most likely, their ages, gender, educational qualification and so on. The researcher gave a brief introduction to the study on the first page of the survey questionnaire. All candidates work as internal auditors in different commercial banks.

In the Preprocessing method, all answers are required to be converted into numerical scores in order to analyse the data and make the statistical calculations. For that, a logic stated in Table 3.6 is applicable.

**Table 3.6: Preprocessing method scores allotment**

| <b>Response type</b> | <b>Preprocessing score</b> |
|----------------------|----------------------------|
| Strongly agree       | 2                          |
| Agree                | 1                          |
| Neutral              | 0                          |
| Disagree             | -1                         |
| Strongly disagree    | -2                         |

The score systems are given in Table 3.6 can be further demonstrated by the following norms:

1. If the response is found “Neutral” then it will be replaced with the value of zero;
2. If the response is found “Agree” then it will be replaced with the value of one;
3. If the response is found “Strongly Agree” then it will be replaced with the value of two;
4. If the response is found “Disagree” then it will be replaced with the value of minus one;
5. If the response is found “Strongly disagree” then it will be replaced with the value of minus two;

However, the algorithm will take the previous points in the processing of the data where each candidate will have his thirty-five answers so that every answer related to the Table 3.6 will be considered for the analysis and the respected answers will be replaced with their relevant values with the light of Table 3.6. Ultimately, each question (parameter) will have a summative score from each candidate where a final

number of scores will be allotted to this parameter (question) after the summation of the responder's scores from all candidates from this particular parameter.

### 3.5.2.1 Applying Preprocessing Method

First of all; the researcher got the Preprocessing method results in Matlab where he can identify and analyze the response for each parameter (question) individually as on the candidate's responses. So to say, each question in the Appendix (I) is being answered from thirty responders where each of them is replied with his own point of view. The responses are swinging among the following possibilities (strongly agree, agree, neutral, disagree, and strongly disagree) so, let us highlight the responses of each question on the mentioned possibilities bases.

**Table 3.7: Responses for questions of survey**

| Question number | Number of strongly agree responses | Number of agree responses | Number of neutral responses | Number of disagree responses | Number of strongly disagree responses | Total of responses |
|-----------------|------------------------------------|---------------------------|-----------------------------|------------------------------|---------------------------------------|--------------------|
| 1               | 8                                  | 17                        | 5                           | 0                            | 0                                     | 30                 |
| 2               | 14                                 | 14                        | 1                           | 1                            | 0                                     | 30                 |
| 3               | 8                                  | 18                        | 3                           | 1                            | 0                                     | 30                 |
| 4               | 6                                  | 16                        | 4                           | 4                            | 0                                     | 30                 |
| 5               | 7                                  | 16                        | 5                           | 2                            | 0                                     | 30                 |
| 6               | 13                                 | 11                        | 2                           | 4                            | 0                                     | 30                 |
| 7               | 12                                 | 15                        | 1                           | 2                            | 0                                     | 30                 |
| 8               | 13                                 | 15                        | 2                           | 0                            | 0                                     | 30                 |
| 9               | 7                                  | 9                         | 10                          | 4                            | 0                                     | 30                 |
| 10              | 10                                 | 19                        | 1                           | 0                            | 0                                     | 30                 |
| 11              | 9                                  | 20                        | 1                           | 0                            | 0                                     | 30                 |
| 12              | 14                                 | 14                        | 1                           | 1                            | 0                                     | 30                 |
| 13              | 20                                 | 8                         | 2                           | 0                            | 0                                     | 30                 |
| 14              | 6                                  | 19                        | 3                           | 1                            | 1                                     | 30                 |
| 15              | 6                                  | 15                        | 6                           | 3                            | 0                                     | 30                 |

|    |    |    |    |   |   |    |
|----|----|----|----|---|---|----|
| 16 | 11 | 17 | 2  | 0 | 0 | 30 |
| 17 | 4  | 12 | 9  | 5 | 0 | 30 |
| 18 | 0  | 12 | 12 | 4 | 2 | 30 |
| 19 | 5  | 11 | 10 | 4 | 0 | 30 |
| 20 | 5  | 15 | 5  | 5 | 0 | 30 |
| 21 | 8  | 15 | 6  | 1 | 0 | 30 |
| 22 | 6  | 13 | 8  | 3 | 0 | 30 |
| 23 | 6  | 18 | 4  | 2 | 0 | 30 |
| 24 | 4  | 11 | 9  | 6 | 0 | 30 |
| 25 | 3  | 13 | 9  | 4 | 1 | 30 |
| 26 | 10 | 17 | 2  | 1 | 0 | 30 |
| 27 | 8  | 17 | 5  | 0 | 0 | 30 |
| 28 | 19 | 10 | 1  | 0 | 0 | 30 |
| 29 | 20 | 8  | 2  | 0 | 0 | 30 |

Figures 3.8 through 3.12 are graphically demonstrating the outcomes so that it can be monitored with ease.

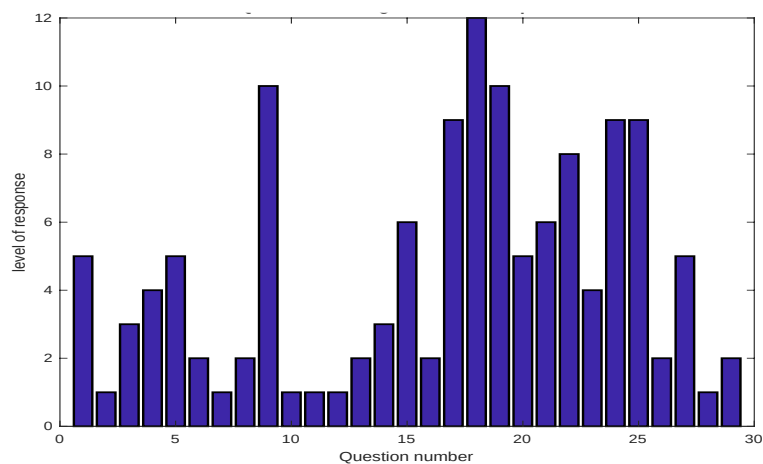


**Figure 3.8: Neutral responses in all questions**

Questions (2, 7, 10, 11, 12, 28) see the appendix (I) have gotten lesser reported neutral response. More likely the questions 2, 7, 10, 11, 12, 28 are having only one responder who reacted with neutral.

On the other hand, question 18 is the maximum reported neutral answer, which got 12 candidates, are neutral from answering it.

**Question 18:** *The Bank's senior management supports the internal audit department with the necessary financial resources is one of the important characteristics of audit quality.*

The same is answered with neutral since it may harsh the integrity of the auditors by supporting them with the fund. It could be due to the way candidates understood the question; however, the motto of this question is about providing the necessary requirement to fulfill the audit process such as machines and similar tools, which may cost a money. Furthermore, candidates have shown neutral answer regarding the question of disclosing the reports (discussion) between the internal and external auditors. Figure 3.8 reveals that ten candidates have shown neutral action for questions 9 and 19.

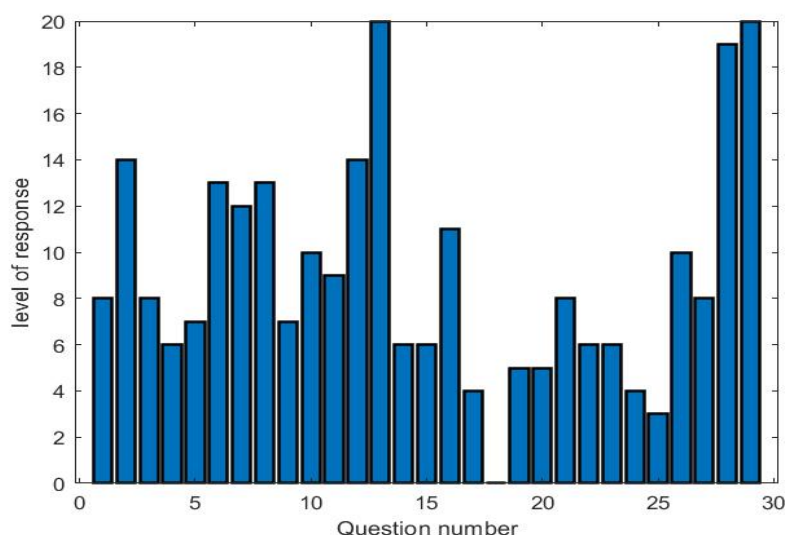


**Figure 3.9: A demonstration of strongly agreed response for all questions**

Figure 3.9 shown that question number 13 and 29 are the topmost answered with “strongly agreed” and nobody is “strongly agree” on question 18.

**Question 18:** *The Bank's senior management supports the internal audit department with the necessary financial resources is one of the important characteristics of audit quality.*

The minimum agreement with this parameter (question 18) as per the strongly agree measure for the same reason given for “neutral” response above. Whereas the majority of the candidates strongly agree with the following parameters:

**Question 13:** *One of the most important means of developing and increasing the quality of the internal audit is training the auditors*

**Question 29:** *The appointment of highly experienced internal auditors positively affects the quality of internal audit management.*

This can be concluded as an experience of internal auditors is a most important factor that enhances the performance of an internal audit process on another hand; staff participating the internal audit may need to be trained for ensuring quality.

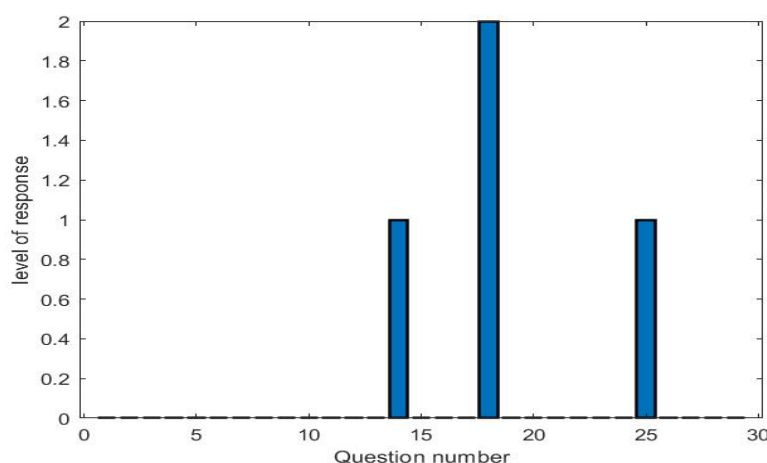


**Figure 3.10: A demonstration of strongly disagreement of the all questions**

As revealed by Figure 3.10, it is clear that all but 3 questions have not got to strongly disagree response. Question number 18 has got only two “strongly disagree” responses.

**Question 18:** *The Bank's senior management supports the internal audit department with the necessary financial resources is one of the important characteristics of audit quality.*

For the same reason of “neutral”, this parameter may harsh the integrity of the auditors so that most of the candidates are tended to be against that.

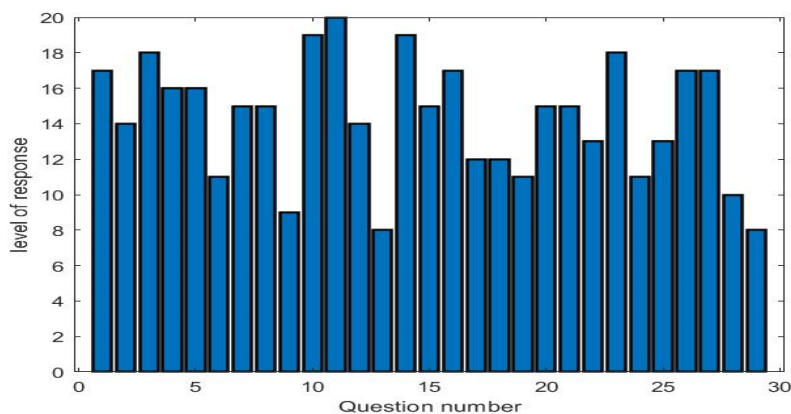


**Figure 3.11: A graphical demonstration of Agree response**

Question number 11 has obtained the top “agrees” responses (20 agree clicks) whereas, question number 13 and 29 are the lesser in “agree” responses (they got only 11 agree clicks).

The question 13 and 29 related to the staff of internal audit, where it is clear that staff must be trained well and highly qualified internal auditors are to be hired, the reason that they got lesser “agree” click is because they already got strongly agreed in previous comparisons.

**Question 11:** *The Internal Audit Department, which is entitled to discuss its reports with the audited departments, is one of the important characteristics of audit quality.*

It got 11 clicks of “agree” responses, which make it the top question with, agree response. This means that most internal auditors have the independence to discuss any department within the bank.

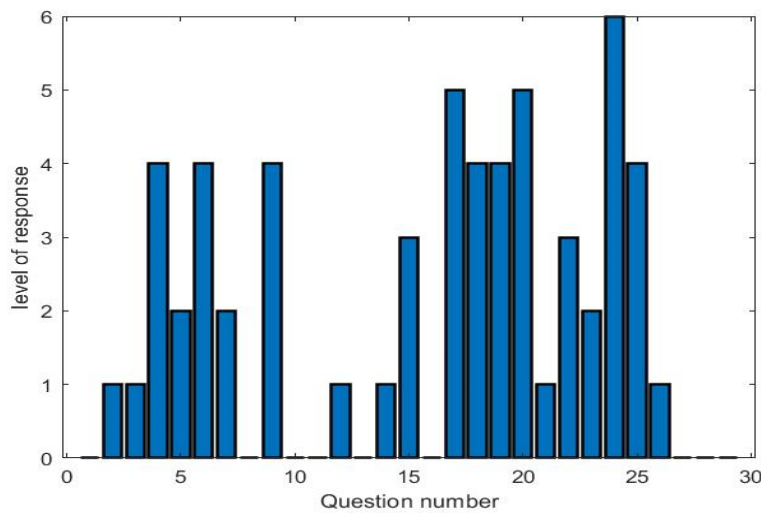


**Figure 3.12: A graphical demonstration of disagreement responses**

Question number 24 has got the maximum responses with “disagree”.

**Question 24:** *Sufficient budget to successfully carry out its duties and responsibilities is one of the important characteristics of audit quality.*

Six candidates have shown their disagreement with this parameter (question 24), whereas questions (1, 8, 10, 11, 13, 16, 27, 28, 29) have no any click of disagreement.

### 3.5.2.2. Final Grade Expression

After defining the logic in the previous chapter where Preprocessing method is used to obtain the scores for questions, in here; the researcher is going to derive the score for each parameter mentioned in the survey. It is important to highlight the following terminologies:

The maximum score in question wise = 60 (base on assumption says all candidates is shown a strongly agreed with reflect 2 units (scores)).

The current score = the score that practically allotted for every parameter after summing the scores (clicks) of all candidates.

Percentage score (PPS):

$$PPS = \frac{PS}{MS} \times 100\% \quad (1)$$

$$PS = \sum_1^n \text{score}(n) \quad (2)$$

Where MS: maximum score;

PS: practical score;

n: number of candidates

Score (n): the score of n<sup>th</sup> candidate

$$\text{Ex: PPS of Q1} = \frac{33}{60} \times 100 = 55\%$$

$$PS = (8 \times 2) + (17 \times 1) + (5 \times 0) + (0 \times -1) + (0 \times -2) = 33$$

$$MS = 2 \times 30 = 60$$

Considering the equation 1, Table 3.8 can be formulated as follows:

**Table 3.8: The outcomes of survey which reflect the percentage score of each parameter (question)**

| Question number | PS | MS | PPS % |
|-----------------|----|----|-------|
| 1               | 33 | 60 | 55%   |
| 2               | 41 | 60 | 68%   |
| 3               | 33 | 60 | 55%   |
| 4               | 24 | 60 | 40%   |
| 5               | 28 | 60 | 46%   |

|    |    |    |     |
|----|----|----|-----|
| 6  | 33 | 60 | 55% |
| 7  | 37 | 60 | 61% |
| 8  | 41 | 60 | 68% |
| 9  | 19 | 60 | 31% |
| 10 | 39 | 60 | 65% |
| 11 | 38 | 60 | 63% |
| 12 | 41 | 60 | 68% |
| 13 | 48 | 60 | 80% |
| 14 | 28 | 60 | 46% |
| 15 | 24 | 60 | 40% |
| 16 | 39 | 60 | 65% |
| 17 | 15 | 60 | 25% |
| 18 | 4  | 60 | 7%  |
| 19 | 17 | 60 | 28% |
| 20 | 20 | 60 | 33% |
| 21 | 30 | 60 | 50% |
| 22 | 22 | 60 | 36% |
| 23 | 28 | 60 | 47% |
| 24 | 13 | 60 | 22% |
| 25 | 13 | 60 | 22% |
| 26 | 36 | 60 | 60% |
| 27 | 33 | 60 | 55% |
| 28 | 48 | 60 | 80% |
| 29 | 48 | 60 | 80% |

The information of Table 3.8 is used to construct the Figure 3.13.

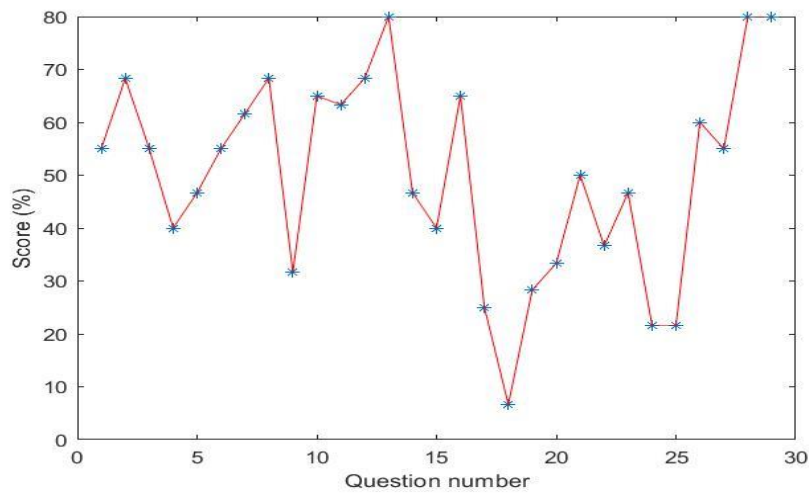


**Figure 3.13: Final percentage score of every parameter in the survey**

### 3.5.2.3. Reorder

In order to analyze and determine which parameters are more important from the point of view of the IAs participating in this study, the factors in the previous table were rearranged according to their effect on the quality term.

The parameters of the IA process can be listed from the most important to the least important in light of the survey conducted as follows:

**Table 3.9: New arrangement of parameters as per the survey results**

| Question number | PS | PPS % |
|-----------------|----|-------|
| 29              | 48 | 80%   |
| 28              | 48 | 80%   |
| 13              | 48 | 80%   |
| 12              | 41 | 68%   |
| 08              | 41 | 68%   |
| 02              | 41 | 68%   |
| 16              | 39 | 65%   |

|    |    |     |
|----|----|-----|
| 10 | 39 | 65% |
| 11 | 38 | 63% |
| 07 | 37 | 62% |
| 26 | 36 | 60% |
| 27 | 33 | 55% |
| 06 | 33 | 55% |
| 03 | 33 | 55% |
| 01 | 33 | 55% |
| 21 | 30 | 50% |
| 05 | 28 | 47% |
| 23 | 28 | 47% |
| 14 | 28 | 47% |
| 15 | 24 | 40% |
| 04 | 24 | 40% |
| 22 | 22 | 37% |
| 20 | 20 | 33% |
| 09 | 19 | 32% |
| 19 | 17 | 28% |
| 17 | 15 | 25% |
| 25 | 13 | 22% |
| 24 | 13 | 22% |
| 18 | 04 | 07% |

The factors that important to maintain in any audit and considered as critical to the internal audit quality are enlisted in Table 3.10; the formulation of these particles is achieved with the light of survey results. The following parameters are to be followed in the same sequential fashion and considering the importance value give for each in Table 3.9.

In Table 3.10, I link each parameter to the hypothesis it represents to make it easier to understand the relative importance of each parameter and to determine the factors (hypothesis) that affect the IAQ in sequential order from top to bottom according to the strength of its effect on the quality.

**Table 3.10: The Parameters in the Order of Importance**

| Question number                                                                                                                                                                                            | Hypotheses                                                                                                      |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|
| 29-The appointment of highly experienced internal auditors is highly affected the IAQ.                                                                                                                     | <b>H5-</b> The level of experience of the internal auditor affects the IAQ of the Libyan commercial banks.      |
| 28. The experience of internal auditor affects the IAQ.                                                                                                                                                    |                                                                                                                 |
| 13.One of the most important means of developing and increasing the IAQ is training the auditors                                                                                                           | <b>H2-</b> The training courses received by the internal auditor affect the IAQ of the Libyan commercial banks. |
| 12.The objectives, functions, and powers of the IAD are issued and clearly defined and detailed and written by the Board of Directors of the Bank is one of the important characteristics of audit quality | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.             |
| 8.The internal auditor's individual responsibility ensures high audit quality.                                                                                                                             |                                                                                                                 |
| 2. The IAD follows the Chairman of the Board of Directors directly is one of the important characteristics of IAQ.                                                                                         |                                                                                                                 |
| 16. Professional qualification of internal auditors is one of the important characteristics of IAQ.                                                                                                        | <b>H2-</b> The training courses received by the internal auditor affect the IAQ of the Libyan commercial banks  |
| 10. Exercises its functions and prepares its reports without any outside interference is one of the important characteristics of IAQ.                                                                      | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.             |
| 11. The IAD, which is entitled to discuss its reports with the audited departments, is one of the important characteristics of IAQ.                                                                        |                                                                                                                 |
| 7. The internal auditor has access to the records, the appropriate persons and so on as is necessary to perform his duty without restriction is one of the important characteristics of IAQ                |                                                                                                                 |
| 26.The speed of completion of internal work by internal auditors increases the IAQ.                                                                                                                        | <b>H5-</b> The level of experience of the internal auditor affects the IAQ of the Libyan commercial banks.      |

|                                                                                                                                                                                  |                                                                                                                 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|
| 27. The internal auditors' knowledge of the nature of the work increases the IAQ.                                                                                                |                                                                                                                 |
| 6. No conflict between the interests of the internal auditor and the interest of the bank is one of the important characteristics of IAQ.                                        | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.             |
| 3. The internal auditor can make decisions without any pressure or obedience is one of the important characteristics of IAQ.                                                     |                                                                                                                 |
| 1. The Director of the Internal Audit Department has the full powers to enable him/her to do his job properly is one of the important characteristics of internal audit quality. |                                                                                                                 |
| 21. The recommendations of the Internal Audit Department are supported by the Bank's senior management is one of the important characteristics of audit quality.                 | <b>H3-</b> The Board of Directors' support for the management of IA affects the IAQ of Libyan commercial banks. |
| 5. The recommendations of the internal auditor are taken in the relevant economic and administrative fields is one of the important characteristics of IAQ.                      | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.             |
| 23. The size of Internal Audit Department impact the IAQ in Libyan Commercial Banks.                                                                                             | <b>H4-</b> The size of the internal audit department affects the IAQ of the Libyan commercial banks.            |
| 14. One of the most important means of developing and increasing the IAQ is training the auditors in abroad.                                                                     | <b>H2-</b> The training courses received by the internal auditor affect the IAQ of the Libyan commercial banks  |
| 15. Scientific qualification of internal auditors is one of the important characteristics of internal IAQ.                                                                       |                                                                                                                 |
| 4. The recommendations of the internal auditor are taken in all financial, accounting and technical aspects is one of the important characteristics of internal audit quality.   | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.             |

|                                                                                                                                                                       |                                                                                                                             |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|
| 22. The senior management of the Bank shall not interfere in the work of the Internal Audit Department is one of the important characteristics of IAQ.                | <b>H3-</b> The Board of Directors' support for the management of IA affects the IAQ of Libyan commercial banks.             |
| 20. The senior management of the Bank believes in the importance of the work and recommendations of the IAD is one of the important characteristics of audit quality. |                                                                                                                             |
| 9. The internal auditor is allowed to investigate the violations independently and in secret is one of the important characteristics of IAQ.                          | <b>H1-</b> The independence of the internal auditor affects the IAQ of the Libyan commercial banks.                         |
| 19. The senior management of the bank supports and encourages the IAD to carry out its duties is one of the important characteristics of IAQ.                         | <b>H3-</b> The Board of Directors' support for the management of internal audit affects the IAQ of Libyan commercial banks. |
| 17. The bank's senior management supports the internal audit department with sufficient human resources is one of the important characteristics of IAQ.               |                                                                                                                             |
| 25. IAD, which is large enough to successfully carry out its duties and responsibilities is one of the important characteristics of IAQ.                              | <b>H4-</b> The size of the internal audit department affects the IAQ of the Libyan commercial banks.                        |
| 24. Sufficient budget to successfully carry out its duties and responsibilities is one of the important characteristics of IAQ.                                       |                                                                                                                             |
| 18. The bank's senior management supports the internal audit department with the necessary financial resources is one of the important characteristics of IAQ.        | <b>H3-</b> The Board of Directors' support for the management of internal audit affects the IAQ of Libyan commercial banks. |

Table 3.10 shows that Hypothesis 5 (experience of internal auditors), Hypothesis 2 (training) and Hypothesis 1 (independence of internal auditors) are the most influential factors in the quality of internal audit (respectively) according to the opinion of the

internal auditors participating in this study, where the questions of these hypotheses got the highest approval rate from the participants.

While Hypothesis 3 (management support) and Hypothesis 4 (department size) are the least influential in the quality of internal audit in the Libyan commercial banks as some participants believe.



## CONCLUSION

There is no doubt that internal auditing is an important part of the corporate governance structure of the institution. This importance was highlighted through the IIA 2130-1 advisory practice on the role of the internal auditor in the ethical culture of the organization, which emphasizes the need for internal auditors to play an active role in supporting the ethical culture of the organization. In this way, it can help to detect the misappropriation of the assets of the organization.<sup>130</sup> Moreover, in order to strengthen the role and authority of the internal audit function, it is essential that each bank has an internal audit charter approved by senior management and confirmed by the Board of Directors. Modern banking operations have become increasingly complex, prompting the heads of organizations to ensure that their employees are sufficiently professional to perform their duties properly.<sup>131</sup>

The banking sector is one of the most significant sectors of the Libyan economy, and one of the main financiers of projects and organizations, due to the adoption of public sector institutions in the implementation of development plans.<sup>132</sup> Commercial Banks in Libya considered as the most important financial institutions in terms of role, size, geographical spread and the range of services provided to customers.<sup>133</sup> The LCBs perform a number of vital functions, such as playing the role of intermediary between savers and borrowers, mobilizing savings, facilitating the flow of payments, allocating credit, and controlling the financial discipline of borrowers. And also provide electronic bank techniques such as paying bills, updating credit data and drawing and transferring money.<sup>134</sup>

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<sup>130</sup> Abu-Azza, op. cit., P. 68.

<sup>131</sup> Basel Committee. (2001). Internal audit in banks and the supervisor's relationship with auditors: A survey. *Basel Committee on Banking Supervision, Basel.*[Google Scholar]. P. 5.

<sup>132</sup> SHERNANNA, H. (2013). *Critical Perspectives on the Efficient Implementation of Privatisation Policies in Libya: Assessing Financial, Economic, Legal, Administrative and Social Requirements* (Doctoral dissertation, Durham University).

<sup>133</sup> Hawashe, A. A. M. (2015). Commercial banks' attributes and annual voluntary disclosure: the case of Libya. *Int. J. Acc. Financ. Reporting*, 5, 208-233.

<sup>134</sup> Colpan, A. M., Hikino, T., & Lincoln, J. R. (Eds.). (2010). *The Oxford handbook of business groups*. Oxford University Press. P. 551.

First, the researcher starts with an introduction to the study. Chapter one provide important information about internal audit such as; historical development, definition and importance of internal audit. The chapter also provides Internal Audit Quality, as well as factors affecting IAQ. In the second chapter, many aspects of Libya's context were highlighted and discussed. Background on Libya, including the Accounting and Auditing Profession in Libya, was presented. The role of the Central Bank of Libya was highlighted as the main regulator and supervisory body and the Bank of Banks. The main issues surrounding the Libyan commercial banks were highlighted, such as obstacles faced by the Libyan banking sector. In addition, the chapter also highlighted the development of Islamic banks in Libya. In the last chapter introduces the study, and highlighted the aims, objectives and the hypotheses of this study. In addition, the chapter discusses the research methodology and methods that are adopted in this study, presents the results from the data collection and analyses these results. Finally, the overall conclusion of the study was presented.

The survey was conducted in 2018. 30 questionnaires were prepared, each containing 35 questions and distributed among 30 Internal Auditors from Libyan Commercial Banks. Questions of the survey were made in two categories, the first 6 questions to understand the identity of responders, and another 29 questions to explore the responder's opinion about the survey questions. Preprocessing method is used to analysis the data in Matlab. The results of the questionnaire indicate that, the internal auditors of the Libyan commercial banks consider Hypothesis 5 (experience of internal auditors), Hypothesis 2 (training) and Hypothesis 1 (independence of internal auditors), as the most influential factors in the quality of internal audit (respectively) according to the opinion of the internal auditors participating in this study. Where the questions of these hypotheses got the highest approval rate from the participants. While Hypothesis 3 (management support) and Hypothesis 4 (department size) are the least influential in the quality of internal audit in the Libyan commercial banks as some participants believe. The study recommended that Libyan commercial banks should ensure the availability of key factors to achieve the quality of the internal audit function.

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## APPENDIX (I)

### Section A: Demographic Information

#### Gender

Male [ ] Female [ ]

#### Age

Below 25 [ ] 25-34 [ ]  
35-44 [ ] 45-50 [ ]  
Above 51 [ ]

#### Qualification

Diploma level [ ] Bachelor's Degree Level [ ]  
Masters Level [ ] Phd [ ]

#### Scientific specialization

Accounting [ ] Banking Sciences [ ]  
Management [ ] Other identified.....

#### How long have you worked in the bank?

Less than 5 years [ ] 5-10 years [ ]  
10-15 years [ ] More than 20 years [ ]

#### Professional Certifications

CIA [ ] CPA [ ]  
ACPA [ ] CA [ ]  
Nothing [ ] Other identified.....

### Section B:

|     | Questions                                                                                                                                                                                        | Strongly agree | agree | neutral | disagree | Strongly disagree |
|-----|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------|-------|---------|----------|-------------------|
| 1-  | The Director of the IAD has the full powers to enable him/her to do his job properly is one of the significant characteristics of IA quality.                                                    |                |       |         |          |                   |
| 2-  | The Internal Audit Department follows the Chairman of the Board of Directors directly is one of the essential characteristics of internal audit quality.                                         |                |       |         |          |                   |
| 3-  | The internal auditor can make decisions without any pressure or obedience is one of the significant characteristics of internal audit quality.                                                   |                |       |         |          |                   |
| 4-  | The recommendations of the internal auditor are taken in all financial, accounting and technical aspects is one of the significant characteristics of internal audit quality.                    |                |       |         |          |                   |
| 5-  | The recommendations of the internal auditor are taken in the relevant economic and administrative fields is one of the main characteristics of IA quality.                                       |                |       |         |          |                   |
| 6-  | No conflict between the interests of the internal auditor and the interest of the bank is one of the key characteristics of internal audit quality.                                              |                |       |         |          |                   |
| 7-  | The internal auditor has access to the records, the appropriate persons and so on as is necessary to perform his duty without restriction is one of the important characteristics of IA quality. |                |       |         |          |                   |
| 8-  | The internal auditor's individual responsibility ensures high audit quality.                                                                                                                     |                |       |         |          |                   |
| 9-  | The internal auditor is allowed to investigate the violations independently and in secret is one of the significant characteristics of IA quality.                                               |                |       |         |          |                   |
| 10- | Exercises its functions and prepares its reports without any outside interference is one of the imperative characteristics of IA quality.                                                        |                |       |         |          |                   |

|     |                                                                                                                                                                                                                              |  |  |  |  |  |
|-----|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|--|--|--|--|
| 11- | The IA Department, which, is entitled to discuss its reports with the audited departments, is one of the important characteristics of audit quality.                                                                         |  |  |  |  |  |
| 12- | The objectives, functions, and powers of the Internal Audit Department are issued and clearly defined, detailed, and written by the Board of Directors of the Bank is one of the important characteristics of audit quality. |  |  |  |  |  |
| 13- | One of the most important means of developing and increasing the quality of the IA is training the auditors.                                                                                                                 |  |  |  |  |  |
| 14- | One of the most vital means of developing and increasing the quality of the internal audit is training the auditors in abroad.                                                                                               |  |  |  |  |  |
| 15- | Scientific qualification of internal auditors is one of the important characteristics of IA quality.                                                                                                                         |  |  |  |  |  |
| 16- | Professional qualification of internal auditors is one of the important characteristics of IA quality.                                                                                                                       |  |  |  |  |  |
| 17- | The Bank's senior management supports the internal audit department with sufficient human resources is one of the                                                                                                            |  |  |  |  |  |
| 18- | The Bank's senior management supports the internal audit department with the necessary financial resources is one of                                                                                                         |  |  |  |  |  |
| 19- | The senior management of the Bank supports and encourages the internal audit department to carry out its                                                                                                                     |  |  |  |  |  |
| 20- | The senior management of the Bank believes in the importance of the work and recommendations of the                                                                                                                          |  |  |  |  |  |
| 21- | The recommendations of the IA Department are supported by the Bank's senior management is one of the important characteristics of audit quality.                                                                             |  |  |  |  |  |
| 22- | The senior management of the Bank shall not interfere in the work of the IA Department is one of the significant characteristics of audit quality.                                                                           |  |  |  |  |  |
| 23- | The size of IA Department impact the IA quality in Libyan Commercial Banks.                                                                                                                                                  |  |  |  |  |  |
| 24- | Sufficient budget to successfully carry out its duties and responsibilities is one of the significant characteristics of audit quality.                                                                                      |  |  |  |  |  |

|     |                                                                                                                                                                        |  |  |  |  |  |
|-----|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--|--|--|--|--|
| 25- | Internal Audit Department, which is large enough to successfully carry out its requirements and obligations, is one of the important characteristics of audit quality. |  |  |  |  |  |
| 26- | The speed of completion of internal work by internal auditors increases the IAQ.                                                                                       |  |  |  |  |  |
| 27- | The internal auditors' knowledge of the nature of the work increases the quality of the IA.                                                                            |  |  |  |  |  |
| 28- | The experience of internal auditor affects the quality of the IA.                                                                                                      |  |  |  |  |  |
| 29- | The appointment of highly experienced internal auditors positively affects the quality of IA management.                                                               |  |  |  |  |  |