

Determinants of Internal Audit Quality in Provincial Government

Meidy S.S. Kantohe ^{a*}, Made Sudarma ^b, Imam Subekti^c, Noval Adib ^d

^{a*} Department of Accounting, Universitas Negeri Manado &
Student of Doctoral Program in Accounting, Universitas Brawijaya, Indonesia

^b Department of Accounting, Universitas Brawijaya, Indonesia

*Corresponding author: meidysskantohe@unima.ac.id

Abstract

This study aimed to provide empirical evidence regarding the quality of local government internal audits from individual auditor input based on knowledge, experience, communication skills, and self-efficacy. The study involved all inspectorate auditors at 16 inspectorate offices in North Sulawesi Province, Indonesia. A saturated sampling method was employed, and 98 respondents participated. This study used the Human Capital Theory and Social Cognitive Theory as a theoretical framework supported by previous empirical evidence. The research results showed that internal auditors were demanded to have adequate communication skills in order to better communicate their sole responsibility in administering the government's finance to head of local governments. Moreover, internal auditors should have stronger self-efficacy concerning their own capabilities in performing auditing. The background of knowledge of internal auditors should be in line with specifications needed to be a qualified internal auditor. Experience is not solely measured by duration of work as internal auditors, but there should be a continuous improvement of their capacity in performing auditing.

Keywords: knowledge, experience, communication skills, self-efficacy, audit quality

1. Introduction

Internal audit roles in local governments proliferate with increasing public demands for government financial management responsibilities in realizing good governance and clean government. Internal audits at local governments in Indonesia are carried out by the inspectorate as of the Government Internal Supervisory Apparatus at the regional level, including the provincial, district, or city levels. Auditing Standards for the Government Internal Supervisory Apparatus define that auditors are civil servants who have a position as an auditor and other parties given full duties, powers, responsibilities, and rights by the official authorized to carry out supervision in government agencies (Permenpan, 2008). The inspectorate carries out internal oversight of state finances management and regional government financial reports for all Regional Apparatus Organizations. It helps prevent fraud in financial statements prepared by local governments. The regional inspectorate assists regional heads, governors, regents, and mayors responsible for presenting accountable and generally acceptable financial reports (Bastian, 2006).

The inspectorate's role as an internal auditor for the local government is increasingly essential for the community, especially during the Covid-19 pandemic. The inspectorate is responsible for overseeing the management of aid funds allocation from the central government to local governments distributed to people affected by Covid-19. The Covid-19 assistance fund allocated by the central government to regional governments is of enormous value, so strict supervision from the inspectorate is necessary to avoid corruption.

As an external auditor appointed by the Indonesian government, the Supreme Audit Agency of Indonesia revealed findings from local governments' audited financial statements and Regional-Owned Enterprises. The Supreme Audit Agency announced 135 non-compliance with statutory provisions and 121 weaknesses in the

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internal control system in the 2016 Second Semester Audit Results Summary (BPK, 2016). Meanwhile, the Regional Government Financial Report of North Sulawesi Province confirmed 33 problems of non-compliance with laws and regulations and 28 weaknesses in the internal control system over asset management (BPK, 2016).

Several corruption cases in districts/cities in North Sulawesi Province showed that the inspectorate had not fully realized good governance and clean government as expected by the government and society. The corruption cases involved the Manado City Government, Talaud Islands District, and Minahasa District (Wolajan, 2016b, 2016a).

Those findings also indicated the weak supervisory function performed by the local government inspectorate. Weaknesses in the internal control system and non-compliance with statutory provisions could lead to corruption, indicating low financial reporting quality. The purpose of this internal control system can be achieved through a quality supervisory function from the internal auditor, as a guarantor of the achievement of internal control objectives (INTOSAI, 2004; Mihret & Yismaw, 2007; Sawyer, Dittenhofer, & Scheiner, 2003).

As internal supervisors, auditors should be able to prevent corruption in local government financial management. Moreover, when referring to the Internal Audit Capability Model (IA-CM), a framework identifies the fundamental aspects needed for adequate supervision in the public sector, the IA-CM inspectorate level of North Sulawesi districts and cities is on average. It is mostly at Level 2 (Infrastructure) and Level 3 (Integrated) (BPKP, 2018). At Level 2, the Government Internal Supervisory Apparatus guarantees that governance processes follow regulations and detect corruption. Level 3 can assess activities' efficiency and effectiveness and provide consultation on governance, risk management, and internal control. According to Halim & Kusufi (2014), the low quality of public sector audits will result in the risk of lawsuits (legitimacy) against government officials and fraud, corruption, collusion, and various irregularities. Chadegani (2011) suggests more research on audit quality in the public sector or the government sector to find out whether there is a relationship, similarity or difference between the two or not.

Local government internal audits are essential to oversee the activities and management of state finances in local governments to build public trust in local governments. According to Rezaee *et al.* (2016), Public trust plays an essential role in seeing the audit function as a value-added service. This trust will increase when auditors focus on the competency value and audit quality. Furthermore, Duff (2004) reveals the need to recruit high-quality individuals with adequate technical and interpersonal skills to improve audit quality.

2.Literature Review

The Financial Reporting Council (FRC) states no single agreed definition of audit quality used as a performance assessment standard (FRC, 2008). Some regulators and standard setters conclude that reaching a consensus on the meaning of audit quality may be impossible (Rezaee *et al.*, 2016). Therefore, the concept of audit quality is still an important issue to research.

According to the General Accounting Office (GAO) (2003), high-quality audits are conducted under generally accepted auditing standards. Nonetheless, audit quality is primarily about auditing standards and people's quality, training, and ethical standards (Chadegani, 2011). The Financial Reporting Council (FRC) argues that skills, personal attributes of audit partners and staff, and the training provided to audit personnel are essential factors that determine auditor quality (FRC, 2008). This opinion is supported by Knechel *et al.* (2013) who define audit quality as a result that is conditional on the presence of specific auditor attributes.

Francis (2011) argues that it is more critical for the input indicator to be at the level of individual involvement than to be combined at the company level. DeFond & Francis (2005) suggest a change in audit quality research from that at the audit firm level to the individual auditor level. Also, Church, Davis, & McCracken (2009) revealed that an in-depth investigation is needed to determine the systematic relationship between auditors' characteristics and the achievement of quality audits. Therefore, this study focuses on audit quality on the input factors at the individual auditor level.

Input factors that affect the audit quality of the individual auditor level are Knowledge (Brown, Gissel, & Neely, 2016; Al Matarneh, 2011; Sila, 2016), Experience (Al Matarneh, 2011; Cheng, Liu, & Chien, 2009; Gul, Wu, & Yang, 2013), and Self-efficacy (Lee, Su, Tsai, Lu, & Dong, 2016). However, previous studies examined audit quality on auditors from different functional spheres. Most researchers apply audit quality to external auditors (Brown *et al.*, 2016; Cheng *et al.*, 2009; Gul *et al.*, 2013; Qi *et al.*, 2015; Sila, 2016) and not many examine internal auditors (Matarneh, 2011; Lee *et al.*, 2016).

Nelson & Tan (2005) state that auditors must have sufficient skills in carrying out a variety of tasks to provide confidence and audit conclusions. Communication skills are essential for internal auditors to be

successful in carrying out their functions. Smith (2005) confirms that internal auditors must have good communication skills to succeed in their careers. Internal auditors' interpersonal, written, and oral communication are useful for understanding audit findings and effectively achieving their responsibilities (Piehl, 2003; Sawyer, Dittenhofer, & Scheiner, 2003; Loss, 2000; Lee *et al.*, 2016).

3 AIMS

This study aimed to provide empirical evidence regarding the quality of local government internal audits from individual auditor input based on knowledge, experience, communication skills, and self-efficacy. The communication skills indicator was adapted from the communication skills article on mindtools.com, one of the most popular digital learning solutions for management and careers.

4 Hypotheses

This study adopts the Human Capital Theory to explain the relationship between knowledge, experience, and communication skills on audit quality. This theory reveals that the higher the quality of human resources, the higher the efficiency and productivity of a country (Becker, 1962). Qualified human resources have the knowledge, experience, and good communication skills.

The Social Cognitive Theory in this study is used to explain the relationship between self-efficacy and audit quality. Bandura (1977) first proposed the self-efficacy construct in the psychology literature and is built from the Social Cognitive Theory. The Social Cognitive Theory is a development of the social learning theory that provides a framework for understanding, predicting, and changing human behaviour. The ability to control and strengthen a person in regulating their behaviour to achieve goal-directed behaviour is called self-efficacy (Bandura, 1997). Self-efficacy determines how individuals feel, think, and motivate themselves and act. However, this Social Cognitive Theory does not directly explain the relationship between self-efficacy and auditor behaviour in achieving internal audit quality and the role of self-efficacy as a mediator to produce internal audit quality.

Charkhabi, Abarghuei, & Hayati (2013) state a relationship between academic fatigue and self-efficacy and learning quality. When facing academic problems, people with high self-efficacy tend not to give up easily and try to find useful solutions to fix problems. Lee *et al.* (2016) show that professional development and self-efficacy directly affect internal government audit quality. Moreover, self-efficacy mediates the effect of professional development on audit quality.

This study empirically tested the mediating effect of self-efficacy in the influence of knowledge and experience on the quality of local government internal audits, in obtaining a more comprehensive picture of the quality of internal audit. Besides, this study also analyzed the influence of communication skills on audit quality empirically in the context of local government internal auditors.

4.1. Knowledge and Quality Audit

Deis & Giroux (1992) state that continuous education and training to increase auditor knowledge impacts audit performance and quality. Educational institutions with a high reputation are likely to produce a better professional audience (Gul *et al.*, 2013). Different levels of knowledge affect the way a person completes work. Gul *et al.* (2013) confirm this opinion, which states that auditors who have higher educational background have better productivity and choose the right approaches in dealing with problems.

The same firmness is stated by Hsu (2010) and Troy *et al.* (2011) that knowledgeable auditors have higher performance, are innovative and can process and integrate existing information. Ye, Cheng, & Gao (2014) reveal that high educational backgrounds help improve auditing quality by individual auditors. High educational experience helps auditors have sufficient knowledge to keep them from failing their duties and, at the same time, allow them to enhance audit quality.

H1: Auditor knowledge has a positive effect on Audit Quality

4.2. Experience and Quality Audit

Bröcheler *et al.* (2004) disclose essential findings related to the view of human capital in accounting firms. Auditor's experience has a varied influence on the performance of Public Accounting Firms—higher auditor experience positively affects performance. Hsu (2010) and Troy *et al.* (2011) stated that experienced auditors have higher performance. Experienced auditors can integrate and reconstruct information, connect separate information, and make the information more consistent and meaningful. According to Tubbs (1992), experienced auditors will understand and identify the type and location of errors more accurately, trace the cause and effect of events, find who is responsible for the incident, and the factors that trigger the incident.

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A study conducted by Mudasir (2011) found that experience affects auditors' ethical considerations. Auditor's ethical consideration is a form of auditor compliance with norms and code of ethics as a vital audit quality factor. Furthermore, Larimbi (2013) states that experience influences scepticism or attitude to not believe the client's information quickly—so auditors always try to get information and other evidence as a comparison. Zahroh (2011) also proves that experience has a positive effect on auditor performance. The quality of the audit represents the performance of auditors.

H2: Auditor's experience has a positive effect on Audit Quality

4.3. Communication Skills and Audit Quality

Someone with good communication skills will convey messages effectively and have accurate instructions to complete assigned tasks (MTD Training, 2012). Communication skills are one of the competencies an auditor must have to improve audit quality. According to Duff (2004), audit quality may improve along with individuals' quality. Palmer (2004) has found that good communication skills are among the core competencies auditors or accountants must have.

Auditor communication skills will increase auditors' potential and improve their quality (Smith, 2005). Communication skills significantly affect the performance of the internal auditors. The excellent performance of an auditor will substantially influence audit quality. The Government Internal Supervisory Apparatus' audit standard as a reference for conducting quality audits for internal government auditors requires auditors to have skills in dealing with other people and communicate effectively, especially with auditors. Auditors must have the ability to communicate verbally and in writing to clearly and effectively convey matters such as activity objectives, conclusions, recommendations and other important issues (Permenpan, 2008).

H3: Communication skills have a positive effect on audit quality

4.4. Self-Efficacy and Audit Quality

Gist & Mitchell (1992) state that self-efficacy is an essential motivational construct that affects individual choices, emotional reactions, effort, control, and persistence. Self-efficacy positively impacts performance because high self-efficacy enables effective regulation of human behaviour through a series of cognitive, affective, and motivational decision processes (Bandura, 1977).

Stajkovic & Luthans (1998) have found a significant correlation between self-efficacy and work-related performance, which means that people who have high self-efficacy will improve their job performance. Randhawa (2004) confirms that the higher the employee's self-efficacy, the higher his work performance will be. High self-efficacy increases the tendency of individuals always to do and complete work well. Cervone, Jiwani, & Wood (1991) observe that individuals with high self-efficacy learn more from feedback, respond more adaptively to the environment, and, over time, can translate their learning into improved performance. The research results by Chen *et al.* (2000) and Phillips & Gully (1997) confirm that high self-efficacy can improve task performance.

H4: Self-efficacy has a positive effect on Audit Quality

4.5. Knowledge, Self-Efficacy, and Audit Quality

Auditor's knowledge from a high educational background affects increasing productivity (Gul *et al.*, 2013). Meanwhile, motivation is an essential factor in improving the auditors' audit judgment (Bonner, 1994; Libby & Luft, 1993). In social cognitive theory, motivation is an external event processed in an assessment before it occurs (Bandura, 1986). This theory recognizes the role of self-efficacy in motivation as a central cognitive force.

High self-efficacy improves performance in various occupational fields, including education, training, sports and management (Shea & Howell, 2000). Individuals with high self-efficacy tend to perform well on a variety of tasks. Conversely, individuals with low self-efficacy tend to avoid tasks and situations that they believe exceed their abilities (Bandura, 1977; Stajkovic & Luthans, 1998).

An auditor's ability to carry out his work is derived from his various competencies, including the auditor's knowledge collection related to the scope of his duties. Auditors with sufficient knowledge have high consistency and a high level of adherence to examination standards (J. Bedard, 1989; O'Keefe *et al.*, 1994). Moreover, auditors' higher level of knowledge will help the audit institution remain successful and last for a long time (Bröcheler *et al.*, 2004). An auditor with high knowledge has a strong self-efficacy to carry out his duties to achieve the predetermined audit quality.

H5: Self-efficacy mediates the effect of knowledge on audit quality

4.6. Experience, Self-Efficacy and Audit Quality

Based on the Human Capital Theory viewpoint, auditors' high experience positively affects performance (Bröcheler *et al.*, 2004). Experienced auditors tend to have higher performance (Troy *et al.*, 2011). Hoy & Miskel (2005) reveal that past performance has a significant impact on individual self-efficacy. Continuous success will increase individual self-efficacy, while failure will create personal doubt and reduce individual self-efficacy. Because the auditor accumulates knowledge and experience while doing their duties to make professional judgments, audit experience and professionalization can influence auditors' professional awareness for better audit quality.

Internal auditors' successful experience is a source of self-efficacy in facing challenges in assignments (Lee *et al.*, 2016). Experience gained through effort and learning from mistakes will form strong self-efficacy (Bandura, 2009). Iskandar & Sanusi (2011), have found that auditors need more experience to increase self-efficacy about their ability to handle complex tasks, which will improve their assessment performance.

H6: Self-efficacy mediates the effect of experience on audit quality

5. Methods

The research was conducted at all 16 inspectorates in North Sulawesi Province. The study population was all internal auditors of the regional government or auditors of the inspectorate at the provincial, district, and city levels. These auditors held a functional position, were active in their duties, and were not leaving the job for one or more reasons. Saturated sampling was used with a census method with 221 auditors and 98 people participating.

This study used Partial Least Square (PLS) to test the hypothesis. PLS can be used for testing and developing theories and testing the relationship between the variables under study with each instrument in the variable.

7. Variable Measurement

Knowledge refers to internal auditors' understanding of their primary duties and functions, internal control systems, accounting standards, auditing standards, and codes of ethics as well as applicable laws and regulations in local government financial management (Gul, Wu, & Yang, 2013; Halim, 2013; Samelson, Lowensohn, & Johnson, 2006; Sila, 2016) and adjusted to the standards of the Government Internal Supervisory Apparatus (Permenpan, 2008). Auditors' experience is seen in terms of the tenure, the frequency of tasks carried out (Cheng, Liu, & Chien, 2009; Gul *et al.*, 2013; Sila, 2016), and is adjusted to auditors' duties.

Communication skills are the ability and intelligence of auditors to communicate orally and in writing, and non-verbal communication in carrying out tasks. Communication skills were measured by adapting to the tools in the mindtolls.com article. Editorial adjustments were made based on studies conducted by Loss (2000), Piehl (2003), Sawyer *et al.* (2003), Smith (2005), and auditing standards of the Government Internal Supervisory Apparatus. The indicator used to measure the auditor self-efficacy variable uses the General Self-efficacy Scale from Schwarzer & Jerusalem (1995) and is also adapted from Iskandar & Sanusi (2011) and Lee *et al.* (2016). Audit quality indicators referred to Sila (2016) and the Government Internal Supervisory Apparatus' auditing standards in Permenpan (2008).

8. Results

8.1 Descriptive Findings

The majority of respondents were women (53.7%). Most of the respondents (58.8%) had worked for more than eight years, and 41.2% had worked for less than seven years. 72.1% of auditors had been assigned for auditing more than 15 times. Most of them held an undergraduate or diploma four degree. The majority of respondents (88.2%) were junior and first auditors, and only 11.8% were intermediate auditors. Most of them were experienced team members, and only 35.5% had ever been team leaders.

8.2 Test Results

Validity refers to the size of each indicator's outer loading on its latent variable. Outer model testing shows the validity value above 0.5 for all indicators. All of these indicators showed a loading factor value bigger than 0.6. Validity can also be determined through the Average Variance Extracted (AVE). An instrument is said to meet convergent validity if it has an Average Variance Extracted (AVE) above 0.5. The variables of knowledge, experience, communication skills, self-efficacy, and audit quality had an Average Variance Extracted (AVE) value bigger than 0.5. Based on cross-loading measurements, overall indicators measuring knowledge,

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experience, professional commitment, communication skills, self-efficacy, and audit quality resulted in a bigger loading factor than cross-loading on other variables.

The composite reliability score on knowledge, experience, professional commitment, communication skills, self-efficacy, and audit quality was bigger than 0.7. Based on composite reliability calculation, all indicators measuring knowledge, experience, professional commitment, communication skills, self-efficacy, and audit quality were reliable. Cronbach's alpha value on knowledge, experience, professional commitment, communication skills, self-efficacy, and audit quality was bigger than 0.6. Thus, based on Cronbach's alpha calculation, all indicators measuring knowledge, experience, professional commitment, communication skills, self-efficacy, and audit quality were reliable.

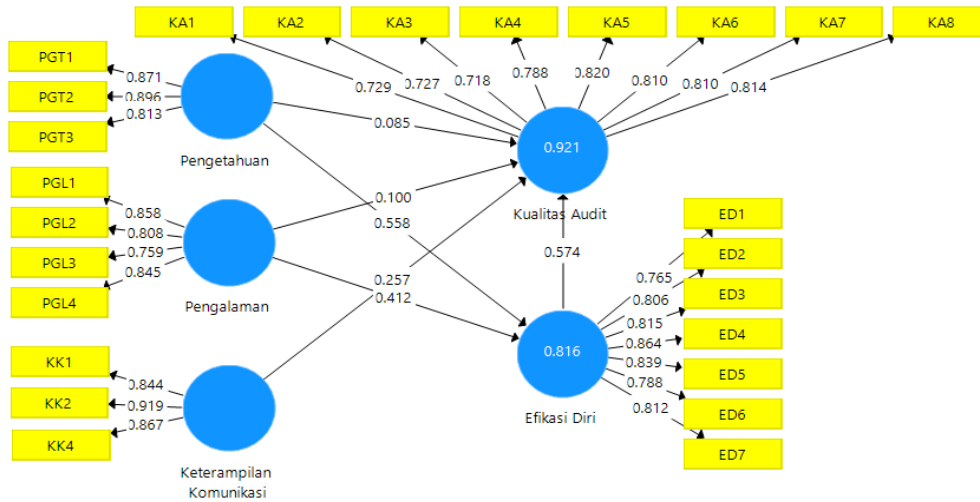


Figure 1. Outer Model Testing Results

Hypothesis Testing: Knowledge has a positive effect on audit quality

Table 1. Path coefficient of knowledge and audit quality

Exogenous	Endogenous	Path Coefficient	t Statistics	P-Value	Information
Knowledge	Audit Quality	0.085	1.833	0.067	Not Significant

Hypothesis Testing: Experience has a positive effect on audit quality

Table 2. Path coefficients of audit experience and quality

Exogenous	Endogenous	Path Coefficient	t Statistics	P-Value	Information
Experience	Audit Quality	0.100	1.547	0.122	Not Significant

Hypothesis Testing: Communication skills have a positive effect on audit quality

Table 3. Path coefficient of communication skills and audit quality

Exogenous	Endogenous	Path Coefficient	t Statistics	P-Value	Information
communication skills	audit quality	0.257	4.481	0.000	Significant

Hypothesis Testing: Knowledge has a positive effect on self-efficacy

Table 4. Path coefficient of self-efficacy and internal audit quality

Exogenous	Endogenous	Path Coefficient	t Statistics	P-Value	Information
Self-Efficacy	Audit quality	0.574	6.791	0.000	Significant

Hypothesis Testing: Self-Efficacy mediates the effect of knowledge on audit quality

Table 5. Path coefficient of knowledge, self-efficacy, and audit quality

Specific Indirect Effect	Path Coefficient	t Statistics	P-Value	Information
Knowledge – Self-efficacy – Audit Quality	0.321	5.180	0.000	Significant

Hypothesis Testing: Self-Efficacy mediates the influence of knowledge on audit quality

Table 6. Path coefficient of experience, self-efficacy, and audit quality

Specific Indirect Effect	Path Coefficient	t Statistics	P-Value	Information
Experience – Self Efficacy – Audit Quality	0.236	5.155	0.000	Significant

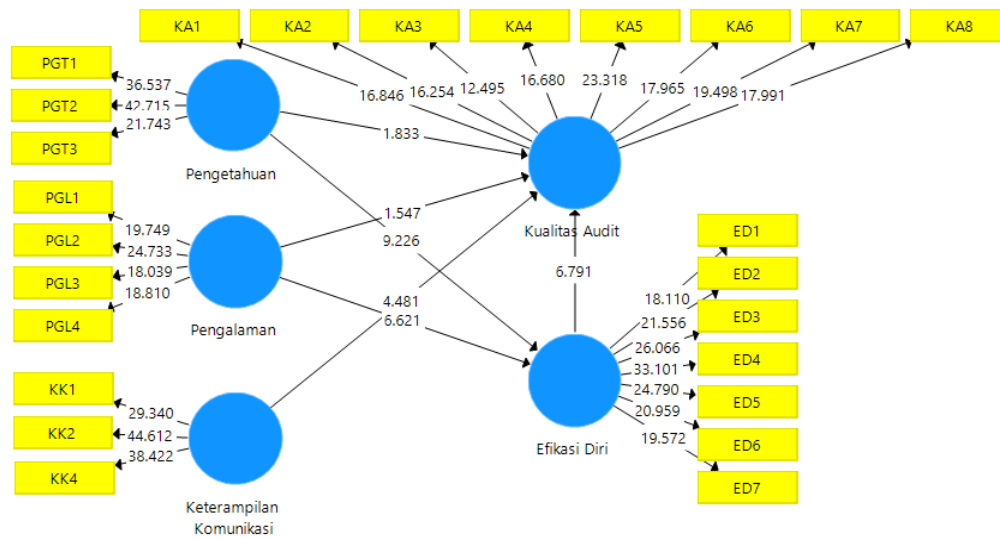


Figure 2.The Inner Model Test Results (Structural Model)

9. Discussion

The **first hypothesis** testing indicates that auditor knowledge of audit quality is positive yet not significant because most of the respondents in this study were junior (50%) and first auditors (38.2%), and only 11.8% intermediate auditors. Intermediate auditors have a higher level of knowledge than junior and first auditors. Brown *et al.* (2016) reveal that junior auditors are not confident with their knowledge compared to their seniors. Junior auditors generally enjoy their jobs because they feel that their supervisors or seniors are supporting their work. Moreover, for local government internal audit context, inspectorate auditors are appointed and dismissed by regional heads. Thus, auditors may face a conflict of interest in their assignment.

The **second hypothesis** testing indicates that the effect of experience on audit quality was positive yet not significant because only a few auditors had been team leaders and technical controllers. As a team member, the auditors' work are evaluated and reviewed by the more experienced team leader and technical controller. Meixner & Welker (1988) explain two types of experiences, namely situational and organizational experiences. Situational experience is the length of time the auditor has served.

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In contrast, the organizational experience is the length of time the auditor has been together with the audit team with a particular role from the lower to the highest level, interacting with all the dynamics it faces. This explanation shows that most of the respondents had sufficient situational experience but still lack organizational experience. Besides, there was also a conflict of interest as an internal auditor.

The **third hypothesis** testing shows the positive and significant effect of communication skills on audit quality. It means that communication skills, as one of the human capitals of internal auditors, are very influential in improving the quality of local government internal audits. These results prove that the indicators of communication skills, adapted from the mindtools website, and then adjusted to the main tasks and functions of the internal auditors, can measure internal auditors' communication skills.

The results also prove that communication skills, as a novelty in this study, are one of the mandatory competencies that the inspectorate auditors must possess and the regional heads must take this competency in selecting internal auditors. Internal auditors need good communication skills in realizing good governance and clean government. They must ensure that the implementation of regional government financial management runs effectively and efficiently following applicable laws and regulations.

The **fourth hypothesis** testing indicates that self-efficacy has a positive and significant effect on audit quality. That is, the higher the self-efficacy, the more likely it is to improve audit quality. The result is in line with the Social Cognitive Theory, which explains that self-efficacy is an individual's belief in their ability to carry out the actions needed to achieve specific achievements (Bandura, 1977). This result is in line with the research of Lee *et al.* (2016) that auditors' self-efficacy, such as a positive attitude towards professional skills and experience, can produce quality audit performance.

These results also support Stajkovic & Luthans (1998) stating a very significant relationship between self-efficacy and work-related performance. The results is also in line with the results of research by Randhawa (2004), Cervone *et al.* (1991), G. Chen *et al.* (2000), and Phillips & Gully (1997) that self-efficacy is positively related to task performance.

The **fifth hypothesis** testing confirms that knowledge has a positive and significant effect on audit quality through self-efficacy, which means that high self-efficacy due to auditors' knowledge can help to improve audit quality. The knowledge can create a quality audit if the auditor has high self-confidence.

Self-efficacy is widely considered crucial in determining how much effort and resources a person invests when facing challenges (Lee *et al.*, 2016). One of the resources possessed by an auditor is knowledge; the knowledge shapes the auditors' self-efficacy of their ability to achieve the expected audit quality.

The **sixth hypothesis** testing indicate that experience affects audit quality through self-efficacy, which means that high self-efficacy due to auditors' experience can help to improve audit quality. As Iskandar & Sanusi (2011) have found that auditors need more experience to increase self-efficacy in facing complex tasks to improve their performance in conducting audit assessments. These results also support Lee *et al.* (2016) stating that experience of internal auditors is a source of self-efficacy to face challenges in their duties and make auditors even more successful in achieving their job performance. Self-efficacy is formed through auditors' experience in doing the assignment as internal auditors and in participating in various seminars, workshops, and continuing professional education

10. Conclusion

Based on the research results and hypothesis testing, the following conclusions are drawn:

1. Communication skills and self-efficacy have a positive and significant effect on the quality of internal audit.
2. Knowledge and experience do not directly affect the quality of internal audit.
3. Self-efficacy fully mediates the influence of knowledge and experience on audit quality.

Based on the conclusions of the, the following suggestions are proposed:

1. It will be better for further research to cover all provinces in Indonesia for larger populations so generalization is even wider.
2. It will be better for further research to differentiate provincial inspectorate offices based on their capability and differentiate auditors based on their functional position.

3. It will be better for further research to use moderating variables to moderate the effect of auditor knowledge on audit quality and auditor experience on audit quality. The test results in this study are not consistent with the results of previous studies.

Author Contributions

Conceptualization: Meidy Kantohe, Made Sudarma, Imam Subekti, Noval Adib

Data curation: Meidy Kantohe

Formal analysis: Meidy Kantohe, Noval Adib

Investigation: Meidy Kantohe, Made Sudarma

Methodology: Made Sudarma, Imam Subekti

Supervision: Made Sudarma, Imam Subekti, Noval Adib

Writing – original draft: Meidy Kantohe, Made Sudarma

Writing – review & editing: Imam Subekti, Noval Adib

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