**THE INFLUENCE OF TOTAL QUALITY MANAGEMENT APPLICATION ON THE INTERNAL AUDIT FUNCTION**

**(A Case Study on SMEs in Palembang)**

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Abstract - The purpose of this study was to determine whether the application of quality management based on customer focused management/ (X1), continuous improvement / (X2), and the employee empowerment / (X3) has a significant influence on the internal audit function either simultaneously or partially on SMEs in Palembang. By using explanatory survey and census techniques, together with Spearman-Rank validity test and Alpha Cronbach reliability test for the research instruments, and by testing the hypothesis by using path analysis, it is indicated that the application of quality management both simultaneously and partially effect significantly to the internal audit function.

Key words: Total Quality Management, Internal Audit Function, SMEs

**A. INTRODUCTION**

The shift in the business environment in recent years is marked by the growth of new small and medium enterprises (SMEs). The ever increasing numbers of SMEs have driven the SMEs to always have to be alert of the changing business environment and the level of competition that keeps growing. Such global competition is a very important factor to be considered by SMEs in business. For each service and product produced by them, they should consider not only how they can market it, but also how they should win the competition with other SMEs and other large companies which at all times constantly innovate their services and products. Recent studies confirm that during the last two decades, the development of new technologies and emergence of new business models has enabled the shift from large corporations to small and new ventures (Thurow, 2003: Minniti et al, 2006). Entrepreneurship contributes to economic performance by introducing innovation, enhancing rivalry and creating competition (Wong et al., 2005).

Nowadays, to be able to face the global challenges, the implementation of quality management by young entrepreneurs that are managing SMEs has become a necessity in all small, medium and large scale business units. Young entrepreneurs representing a well-recognized and respected activity in society can determine its extent. Entrepreneurship recognition reflects the cultural and social values, inherited and developed over time (Bosma et al., 2009; Nature and Taher, 2009; Alvarez et al., 2010).

Of the many young entrepreneurs who were involved in SMEs in Indonesia either directly or indirectly that have applied the principles of quality management, it is found that there are various irregularities committed by unscrupulous employees. The deviation has caused constraints the SMEs in their effort to meet customer satisfaction. This implies the weak internal audit function to support the company's efforts to meet customer satisfaction. This condition is weakened by the lack of competence and professionalism of the internal auditor, as well as their lack of understanding of the principles of quality management resulting in poor internal audit function in meeting the expectations of its internal and external customers (Hiro: 2003; Eddie : 2003; Khomarul : 2002).

The importance of improving the effectiveness of the quality application, which is the target of quality management, has become an important issue not only within the scope of local business but also in international business, especially in the era of global free trade. So, by improving the overall quality of products and services produced, and by the existence of the good internal audit function's position as the key that helps achieve the corporate goals in their efforts to meet customer satisfaction, it is not impossible that Indonesia will emerge as the "new tiger of Asia" because of the movements made by the SME businesses in Indonesia.

**B. FRAMEWORK AND HYPOTHESES**

**B.1. Framework**

Several researchers have focused more directly on the obstacles that hinder the ability of organizations to make a successful transformation to TQM or quality management. Glover (1993:50-63) argues that TQM failures follow one of three patterns: conceptual weakness, design flaws, or ineffective implementation. Recognizing that TQM requires a true organizational transformation, Glover explains conceptual weakness as failures occurring because organizations make only “superficial” attempts at change. Design flaws occur when TQM systems are not designed to fit the cultural circumstances of the organization. And the most common reason for failure— ineffective implementation—results when “TQM becomes so much extra work instead of a new way of doing things”. Glover also argues that without a change in management evaluation and reward policy, TQM cannot be taken seriously. He advocates “managers will need to know that their evaluations, and subsequent pay increases and bonuses, are dependent on having high levels of quality, satisfied staff and consumers, and successful TQM implementation in their respective areas of responsibility”.

Implications of the implementation of quality management, through the involvement of all levels of an organization that is supported by various means and programs related, have a great impact on the culture, attitudes and activities of the organization as well as on the internal audit profession that is required to participate and get involved with adjusting control system that is consistent with quality management strategy (Hawkes et al: 1994; Rezaee: 1996). Employee involvement and empowerment that characterize the quality of management is also a trigger for a paradigm shift in which the internal audit function, which was originally merely an independent consultant on organizational control systems, has become a part of a work team that supports the creation of the changes that is customer oriented.

Implementation of quality management has forced the authorities, that is the Institute of Internal Auditors, to shift their paradigm on the function of internal audit to be more customer oriented with a focus on creating added value through the services provided by the internal audit function to the organization (Raider: 1999; Hiro: 2003; Sawyer : 2003; Chapman et al: 2002; Ramamoorti: 2003; Baumgartner: 2004; Flesher: 2000; Bou-Raad: 2000; Moeller: 2004: Ridley: 1997). It has been demonstrated empirically in which the survey results show that the application of quality management has changed the roles and responsibilities of internal audit function, where at a time was only to audit and assess a company's internal control compliance, to become more focused on a review of the quality management system. In general, it was concluded that although the application of quality management does not conflict with the role of internal auditors, the internal auditor must adjust its role in the implementation of quality management (Sawyer: 2003; Meegan et al: 1997; Rezaee: 1996, Hawkes et . al.: 1995).

**B.2. Hypothesis**

The application of quality management factors affects the overall operational and functional aspects of the organization. Internal audit function is included as one of the factors. So, the activities and scope of internal audit function are influenced by the other factors of quality management. Thus, this research hypothesis can be formulated as follows:

Hypothesis 1: The application of quality management based on the customer focused management, continuous improvement, and employee empowerment has a significant effect on the Internal Audit Function simultaneously.

Hypothesis 2: The application of quality management based on customer focused management, continuous improvement, and employee empowerment has a significant effect on the Internal Audit Function partially.

**C. RESEARCH METHODOLOGY**

**C.1. Research Method**

This study is a verification of research by using Survey Explanatory method. Purposive sampling was used for the data collection and sample selection, with the sampling criteria as follows:

1. SMES that have internal audit function

2. SMEs that have been established since 2008

Based on these criteria, 36 SMEs were selected. The data on the number of SMEs in Palembang was obtained from the Central Bureau of Statistics Palembang .

**C.2 The objects of the study**

**C.2.1. Application of Quality Management**

TQM is an integrated management philosophy and set of practices that emphasizes, among other things, continuous improvement,meeting customers’ requirement, reducing rework, long range thinking, increased employee involvement and teamwork, process redesign, competitive benchmarking, teambased problem-solving, constant measurement of results, and closer relationships with suppliers (Ross, 1994). Similarly, Oakland (1993,p. 22) defines TQM as “…an approach to improving the competitiveness, effectiveness and flexibility of a whole organization”

This variable is measured by the instruments developed by Blocher et.al (1999: 167) which were developed based on the philosophy of quality management principles of Deming. The instrument consists of 42 items grouped into three sub-variables by using a 5-point Likert scale response option, which is modified in such a manner in accordance with the conditions and purpose of the study.

**C.2.2. Internal Audit Function**

Internal Audit function in this study is defined according to the definition of the Institute of Internal Auditors (1999) in Sawyer (2003: 8-10) that “*internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organizations’ operations. 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 process*“. Aligned with the implementation of quality management within the organization, Rezaee (1996) emphasizes that the internal audit function should be tailored to the principles of quality management through which internal improvements and responding to external customers, internal auditors can provide a new form of service for all levels of management.

 This variable is measured with instruments that had been tested and developed by Hawkes et.al (1995), and then modified according to the new paradigm of the internal audit function as described in the definition of internal audit function which was developed by the Institute of Internal Audit. The instrument consists of questions that are grouped into 1 *construct* by using a 5-point Likert scale response option, which is modified in such a way as to the conditions and purpose of this study.

**D. RESULTS AND INTERPRETATION**

 **D.1. Validity and Reliability tests**

Prior to a discussion on how much influence the implementation of quality management that includes the customer focused (X1), continuous improvement (X2), and employee empowerment (X3) has on the internal audit function (Y) on SMEs in Palembang, the validity and reliability of data obtained on the questionnaire answers from respondents were tested first.

**D.1.1. Validity of Test Results**

The validity test on the *customer focused* sub-variable by using the Spearman rank correlation showed that all statements were valid, where the smallest correlation coefficient value was 0,265 and the largest correlation coefficient value was 0,878.

The validity test on the *continuous improvement* sub-variable by using the Spearman rank correlation showed that all statements were valid, where the smallest correlation coefficient value was 0,327 and the largest correlation coefficient value was 0,681.

The validity test on the *employee empowerment* sub-variable by using the Spearman rank correlation showed that all statements were valid, where the smallest correlation coefficient value was 0,348 and the largest correlation coefficient value was 0,875.

The validity test on the *internal audit function* variable by using the Spearman rank correlation showed that all statements were valid, where the smallest correlation coefficient value was 0,458 and the largest correlation coefficient value was 0,763.

**D.1.2. Reliability of test results**

The reliability coefficient of the 20 sub-items on the statement of *customer focused* application variables by using alpha-cronbach test is 0.886. This reliability coefficient indicated that the 20 statements are reliable to measure the implementation of customer focused on SMEs in Palembang.

The reliability coefficient of the 17 sub-items on the statement of *continuous improvement* application variables by using alpha-cronbach test is 0.869. This reliability coefficient indicated that the 17 statements are reliable to measure the implementation of continuous improvement on SMEs in Palembang.

The reliability coefficient of the 11 sub-items on the statement of *employee empowerment* application variables by using alpha-cronbach test is 0.867. This reliability coefficient indicated that the 11 statements are reliable to measure the implementation of employee empowerment on SMEs in Palembang.

The reliability coefficient of the 12 sub-items on the statement of *internal audit function* application variables by using alpha-cronbach test is 0.873. This reliability coefficient indicated that the 12 statements are reliable to measure the implementation of internal audit function on SMEs in Palembang.

 **D.2.2. Hypothesis Testing**

The hypothesis testing which used path analysis required a set of interval scale data, Before calculating the influence of each independent sub-variable on the internal audit function in the SMEs in Palembang, the correlation between the variables, and the calculation results obtained from the correlation coefficient between the variables were calculated and arranged in a matrix form as follows:

**D.2.2.1. Path coefficients**

By using the existing values ​​in the correlations matrix among the variables above, the path coefficient obtained for each sub-independent variable as follows:

**Table 1. Summary of Results of path coefficient**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Influence between variable** | **Path coefficient** | **T count** | **T critical** | **F value** | **Test** | **R Square coefficient** | **Other variables coefficient**  |
|
| X1 to Y1 | 0.3031 | 2.334 | 2.05 | 21.546 | Ho Denied | 0.7388 | 0.2612 |
| X2 to Y1 | 0.3885 | 2.565 | 2.05 | Ho Denied |
| X3 to Y1  | 0.2848 | 2.153 | 2.05 | Ho Denied |

Once the path coefficients were obtained, how much influence the application of customer focused, continuous improvement and employee empowerment sub-variables on the internal audit function on SMEs in Palembang can be calculated. The simultaneous influence is commonly known as the coefficient of determination. The coefficient of determination is 0.7388 or 73.88%. This coefficient of determination can be interpreted as the influence of independent variables to the dependent variable. So in this study 73.88% of internal audit functions in SMEs in Palembang are affected by the implementation of customer focused, continuous improvement and employee empowerment. The influence of other factors not examined in this study is 0.2612 or 26.12%. So the influence of other factors not examined on the function of internal audit on SMEs in Palembang is equal to 26.12%.

**X1**

**ε**

**X3**

**X2**

**0.0781**

**0.0771**

**0.1293**

**Py,x1=0.3031**

**Py,x2=0.3885**

**Py,x3=0.2848**

**Figure 1 Path diagram and path coefficients sub-variable X to Y**

**D.2.2.2 Simultaneous path coefficient testing**

To find out whether simultaneous application of customer focused, continuous improvement and employee empowerment have a significant effect on the internal audit function of SMEs in Palembang, F test was used to test the above hypothesis as follows:

H0 is rejected if F > . At a significance level of 0.05 and degrees of freedom (3; 36-3-1), the F (0.05; 3:32) = 2.9467. The Fcount obtained is 28.336, which means that Fcount > Ftable, then H0 is rejected. So based on the test results with 95% confidence level, it can be concluded that the implementation of customer focused, continuous improvement and employee empowerment simultaneously has a significant effect on the internal audit function on SMEs in Palembang.

This supports the previous research conducted by Hawkes et.al (1995), Meegan et al (1997) and statements by Rezaee (1996), Andi and Iskandar (2009) and Sawyer (2003). The implementation of quality management within an organization will change the pattern of activity of an organization in a comprehensive and sustainable manner. Organizations are required to be able to respond to customer expectations and satisfaction well. Focusing on customers is a major factor that should be the benchmark for routine activities of the organization. As a process, meeting customers expectations must not be done in a short time and thus require continuous improvement and relentless effort.

As an integral part of an organization, the response of the internal audit function becomes a key factor in its efforts to meet the expectations of its internal and external customers. Internal auditor function is required to be able to respond to customer expectations and it should equip itself with a variety of technical skills in order to perform a variety of continuous improvement as demanded by customers.

**D.2.2.3 Partial Path Coefficients testing**

After concluding the influence of the simultaneous application of customer focused, continuous improvement and employee empowerment on the internal audit function in SMEs in Palembang, a test was carried out to see which sub-variable of the three sub-variables that has a significant influence on the function of internal audit on SMEs in Palembang. A t-test was used to find it out.

**D.2.2.3.1. Effect of Implementation of Customer Focused application on
Internal Audit Functions**

H0 is rejected if **|t-count| > ttable**. The t-student with a significance level (0.05) and degrees of freedom (nk-1), (t (0.05) / 2; 32) is 2.0484. Since **t-count** is 2.34 for sub-path variable of customer focused is greater than **ttable**, then with 95% confidence level, it can be concluded that the sub-variable customer focused application has a significant influence on the internal audit function on SMEs in Palembang.

**Table 2** The influence of the implementation of customer focused application

|  |  |
| --- | --- |
| Influence of the implementation of customer focused application on internal audit function | Influence |
| Directly | 9.19% |
| Indirectly | 13.03% |
| Total | 22.22% |

The implementation of customer focused directly influence the internal audit function for about 9.19% in SMEs in Palembang and indirectly at about 13.03%.

In general, the influence of the application of customer focused on internal audit function in SMEs in Palembang is equal to 22.22%. The application results in a positive effect on internal audit function in SMEs in Palembang which means the customer focused application will improve the internal audit function on SMEs in Palembang.

The results of this study support the statement of Sawyer (2003), Rezaee (1996) and empirical studies of Hawkes et al (1995),Andi and Iskandar (2009). Focusing on customers is a central feature of the implementation of quality management. It requires commitment and relentless efforts in order to obtain customer satisfaction on products / services offered by the manufacturer. That also applies to the internal audit function. Implementation of quality management in an entity also affects the activity of the internal audit function. Internal audit function should be more customer oriented. So by changing the orientation of the internal audit function, from which was originally only focused on assessment of compliance audits and internal control, with the implementation of quality management in the company, internal audit function will have an even greater role in the review of the quality system in the company. Thus, the internal audit function will provide an added value through the services provided to customers.

**D.2.2.3.2. Effect of Implementation of *Continuous Improvement* application on
Internal Audit Functions**

H0 is rejected if **|t-count| > ttable**. The t-student with a significance level (0.05) and degrees of freedom (nk-1), (t (0.05) / 2; 28) is 2.0484. Since **t-count** is 2.565 for sub-path variable of continuous improvement is greater than **ttable**, then with 95% confidence level, it can be concluded that the sub-variable continuous improvement has a significant influence on the internal audit function on SMEs in Palembang.

**Table 3 The influence of the implementation of continuous improvement**

|  |  |
| --- | --- |
| Influence of the implementation of continuous improvement on internal audit function | Influence |
| Directly | 15.10% |
| Indirectly | 15.52% |
| Total | 30.62% |

The implementation of continuous improvement directly influences the internal audit function for about 15.10% in SMEs in Palembang and indirectly at about 15.52%.

In general, the influence of the application of continuous improvement on internal audit function in SMEs in Palembang is equal to 30.62%. The application results in a positive effect on internal audit function in SMEs in Palembang which means the continuous improvement application will improve the internal audit function on SMEs in Palembang.

The impact of a paradigm shift that is more oriented to the demands of the customer is the creativity of the people in charge. As stated by Sawyer (2003), Hawkes et al (1995), Rezaee (1996), and Bou-Raad (2000), Andi and Iskandar (2009) that one of the real implications of the implementation of quality management to change the orientation of the company to focus on customers is a continuous improvement. Continuous improvement as part of the company's efforts in meeting customer expectations and satisfaction will require firms to make significant changes in rapid and in accordance with the wishes of the customer. Creativity of employees (including the internal audit function) is the main factor to make this happen. Creativity accompanied by the availability of skills and adequate technical expertise is also absolutely needed the internal auditors. Continuous improvement performed by internal audit function is marked by a more technical approach to developing relevant and more visible role in providing input and suggestions for improving the quality of the company as a whole. So, continuous improvement of the internal audit function will enable the company to respond to various demands and expectations of customers.

**D.2.2.3.3. Effect of Implementation of *Employee Empowerment* application on
Internal Audit Functions**

H0 is rejected if **|t-count| > ttable**. The t-student with a significance level (0.05) and degrees of freedom (nk-1), (t (0.05) / 2; 28) is 2.0484. Since **t-count** is 2.153 for sub-path variable of employee empowerment is greater than **ttable**, then with 95% confidence level, it can be concluded that the sub-variable employee empowerment has a significant influence on the internal audit function on SMEs in Palembang.

**Table 4 The influence of the implementation of employee empowerment**

|  |  |
| --- | --- |
| Influence of the implementation of employee empowerment on internal audit function | Influence |
| Directly | 8.11% |
| Indirectly | 12.93% |
| Total | 21.04% |

The implementation of employee empowerment directly influences the internal audit function for about 8.11% in SMEs in Palembang and indirectly at about 12.93%.

In general, the influence of the application of employee empowerment on internal audit function in SMEs in Palembang is equal to 21.04%. The application results in a positive effect on internal audit function in SMEs in Palembang which means the employee empowerment application will improve the internal audit function on SMEs in Palembang.

The results are in line with the Hawkes et.al (1995), Rezaee (1996) and Andi and Iskandar (2009) in which the optimal empowerment of employees will support the overall activities of the company to meet customer expectations. Particularly the internal audit function, through the empowerment of the optimum by either internal customers or the board audit committee of the company, will increase the competence and professionalism of internal auditors. For example, the involvement of internal audit functions in quality control and inspection of internal quality assurance requires skills and expertise, for example, understanding of the principles and rules of quality management. Thus, the internal audit function is required to be able to communicate and have the technical expertise to assist the department in reviewing the feasibility of production in the existing system.

**E. CONCLUSION**

**E.1. Conclusion**

Based on the results of research conducted to determine the effect of quality management implementation on the Internal Audit Function in SMEs in Palembang, the following conclusions are made:

* Implementation of quality management and internal audit functions in the companies that are the subjects of this study can generally be said to have been good. This is reflected by the scores obtained from tests on the quality of management and internal audit functions variable. Relatively routine internal quality checks indicate a high awareness of quality improvement as an effort to fulfill customer satisfaction. Although in practice, there are still complaints from both external and internal customers of the company, it might be because the application of quality management requires a constant effort to meet customer satisfaction and maintaining the customer satisfaction to establish the achievement of corporate performance.
* Implementation of quality management consisting of Customer Focused application, Continuous Improvement, and Employee Empowerment, has a positive effect simultaneously and partially on to the Internal Audit Function in SMEs in Palembang.

**E.2. Suggestions and Limitations**

**E.2.1. Suggestions**

* Based on the results of hypothesis testing that showed a positive effect of the application of quality management which comprises customer focused application, continuous improvement and employee empowerment, it is recommended to the leaders of the company that they improve the factors of quality management as a whole. It is very important because the application of quality management is an endless endeavor. Necessary commitment and continuous effort in order to keep customer satisfaction should be met. Therefore, the role of internal audit function should be involved in order to accommodate this.
* Compared to other sub-variables of the application of quality management, employee empowerment sub-variable has the smallest positive influence on the internal audit function. It is therefore recommended to the leaders of SMEs to further increase focus on employee satisfaction, give incentives for employees who perform best, increase the intensity of training mainly on technical improvement of the quality of products to employees, and enlarge the authority for employees to make their own decisions for solving quality problems in his work.
* The role of internal auditors should be more empowered to solve problems of quality to customer satisfaction and compliance efforts to reverse the internal audit function should continue to adopt quality management principles in their activities so as to meet customer expectations and satisfaction of internal customers primarily through the services it provides.
* The new paradigm of internal audit function, which has been oriented to focus on customer satisfaction, expands the scope and authority of the internal audit function in providing services to both internal and external customers. To that end, the internal audit function should equip themselves with education and training and to develop new techniques and approaches in the implementation of their duties so as to support continuous quality improvement as expected by customers.

**D.2.2. Limitation**

This study has several limitations or drawbacks. Limitations in this study are expected to be addressed by the next research.

* The first limitation lies in the sample used. Although the sample of this study is actually the population, given the scope of the study sites only focus in Palembang, the research result is not relevant to generalize the application of quality management that affect the function of internal audit in Indonesia. Therefore, subsequent researchers are expected to take a larger sample in order to obtain a representative picture of conditions that affect the application of quality management of the internal audit function in Indonesia.
* A Second limitation is the object of research on the internal audit function. Although this study refers to the instruments developed by previous researchers to modify the internal audit function, but the instrument was still related to the old paradigm of internal audit function. Due to the limitations in developing instruments that are relatively more relevant, the next researcher is expected to perform a series of preliminary test of the instrument variables so that the internal audit function may be more relevant to the research conducted.

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