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The extent of internal audit functions outsourcing by Nigerian deposit money banks

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Abstract

This study attempts to establish the extent to which internal audit functions (IAFs) are outsourced by the consolidated conventional banks in Nigeria, now addressed in the country as deposit money banks (DMBs). The extent to which the banks outsource each of the 15 identified functions traditionally attached to the internal audit unit/department is tested, using a structured questionnaire to elicit responses from the top and middle level management staffs of the banks. Bank' management normally establishes and safeguards internal control system and internal audit system. Accordingly, heads of operations, branch managers, regional/area managers and internal auditors/controllers of all the 22 DMBs existing in Nigeria as at 31st July, 2013 are used as respondents. 25 copies of the questionnaire are administered to the targeted respondents from each of the 22 banks, making a total of 550 copies. Of the copies returned, 435 (79%) are accepted for analysis. As the data are collected on an ordinal scale, non-parametric confirmatory analysis is employed. The study finds that all the 15 identified IAFs are being outsourced by the Nigerian DMBs at varying degree (completely, partially, occasionally or rarely). It is also discovered that 6 IAFs stand out as those that are more outsourced than provided in-house by the Nigerian DMBs (going by the 50% and above scores they attracted from the respondents), and that the other 9 IAFs are more discharged in-house than outsourced to outside experts.

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1. Introduction

The separation of management from ownership of companies, as per the laws of almost all the countries in the world, necessitated the need for both internal and external auditors, and the external auditor is statutorily mandated to express an independent opinion on the truthfulness and fairness of the financial statements prepared by management thereby affirming authenticity to them and adding credibility to them. External auditor also provides assurance service against fraud and misrepresentation of the financial information. This enables users of the financial statements to rely on the company's financial statements for their decisions. Internal audit unit, being an important part of corporate governance and being one of the three monitoring mechanisms identified in the corporate governance literature, is usually set up to play the role of assessing the effectiveness and efficiency of internal control system (Arena & Azzone, 2009).

Thus, the roles of both the internal and external audit functions are receiving increasing importance and attention. External auditing plays a vital role in any financial system and the economy in general. The evidence of its importance is provided by the fact that all public and large private companies, government and all registered non-profit organizations are required to have their financial statements audited annually.

The importance of the internal audit can be seen from the introduction of tougher and stricter rules and guidelines concerning internal control system. Therefore, auditing, both external and internal, should enhance the quality and reliability of financial statements, through the deterrence of manipulation or misrepresentation of accounting information. Thus, the deterrence effect of auditing promotes public confidence, as the exercise enables users to rely on the financial statements of a reporting entity. This ultimately enhances the overall performance of the reporting entity.

Consequently, the role and the required technical skills of the internal auditor has been the subject of discussion among professional accountants and academics, particularly in the light of the revision, by the Institute of Internal Auditors (IIA), of its definition of internal auditing, which widened the scope of internal audit to evolve from its traditional compliance auditing to a stage where it is regarded as a value adding service to organizations (Enyue, 1997; Roth, 2000; Bou-Raad, 2000; Al-Twaijry et al., 2003; Goodwin, 2004; Moeller, 2005; Arena & Azzone, 2009).

Specifically, the IIA in its latest definition defines Internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. This enlarged role has increased the importance of internal auditing as part of the organization's management control system. At the same time it has also increased the demands being put on internal auditors. Their new role requires higher skills and knowledge than before. Many organizations are faced with the choice of whether to develop these broader competencies internally or to outsource internal audit functions to outside service providers (Ahlawat & Lowe, 2004).

Majority of scholars in management suggest that core organizational activities/functions should be performed in-house while non-core could be outsourced to external service providers (Mullin, 1996; Hilman & Warokka, 2011), but empirical researches have shown that it is not only non-core services that are to be outsourced but services closer to core (Harland, et al., 2005), such as internal audit functions (IAF).

This study focuses on the extent to which internal audit functions outsourcing is practiced by the Nigerian deposit money banks. The study attempts to establish the extent to which these banks outsource each of the fifteen identified functions traditionally attached to the internal audit unit/department. This paper is structured into five sections, with this introduction as section 1. Section 2 reviews extant literature. Section 3 states the methodology. Section 4 presents results and discussions, while section 5 concludes the paper.

2. Literature review

Auditing as a field of study (either external or internal) enjoys a wealth of literature due mainly to the fact that it is a rule-based practice all over the world. Many conceptual and empirical research works are in the literature on

the importance of auditing in ensuring effective corporate governance. The specific issue of internal audit functions outsourcing is also beginning to enjoy some appreciable wealth of literature.

In the United States, for example, there were concerns about outsourcing of internal audit functions due to accounting scandals which called for the subsequent enactment of the strict reporting requirements as imposed by Sarbanes-Oxley Act, which lays great emphasis on corporate governance. The Act was enacted to curb the increased possibility of loss of control and breaches of compliance with regulatory requirements, which led researchers to conclude that outsourcing of finance and accounting functions (especially internal audit) may not be feasible (Desai & Mcgee, 2009).

But outsourcing of these functions seems to be on the increase even after Sarbanes-Oxley Act. Desai and Mcgee (2009) stated that the significant savings provided by outsourcing is compelling organizations to outsource. They further stated that statistics have indicated that the global finance and accounting outsourcing market has grown by more than forty-five percent (45%) by the beginning of 2005 and they predicted the growth to be on the increase thereafter.

In the light of the corporate scandals across the world, many organizations were reviewing their internal audit functions (Aldhizer et al. 2003; Speklé et al., 2005). They were considering their sourcing options, which was either in-house or outsourced to outside professionals. They were considering these options voluntary or forced by new laws, regulations, and guidelines such as the Sarbanes-Oxley Act (SOA) and SEC rules and their local counterparts all over the world. Even though it may look as if these laws and regulations appear to be in favor of in-house IAF, Aldhizer et al (2003) explained that outsourcing is still allowed to be provided by these bodies if the organization is to retain management of the IAF and the service provider is not the external auditor of the organization.

Cervantes (2008) claimed that the market for finance and accounting outsourcing (FAO), which include IAF, has grown by 45% since 2005 and has reached expenditures of \$2 billion in the US, and has accounted for close to 50% of the FAO market. The major threat posed by SOA to finance and accounting outsourcing that could restrict outsourcing of internal audit functions has been dealt with effectively by the service providers and is no longer a deterrent to outsourcing (Mcgee, 2005).

The Institute of Internal Auditors (IIA) in its earlier definitions of internal audit shows preference to in-house internal audit functions (IAF). But in its definition of internal audit, in its latest position paper (2009), IIA seems to accept the need for outsourcing of the internal audit functions to third parties, when it removes the phrase which says that the internal audit functions are to be “carried out by an employee of the organization”. This unequivocally is an acceptance of outsourcing of the IAF by the IIA. In the same vein the perspective of IIA is that:

Internal auditing, regardless of who provides the service should be performed in conformance with the standards. The IIA believes that a fully resourced and professionally competent staff that is a key part of the organization, whether in-house or outsourced, best provides internal audit services. The IIA recognizes that many partnering arrangements with outside service providers have been effective in helping organizations obtain internal audit services that contribute to management’s strategic objectives (IIA, 2009 as cited in Kamyabi & Devi, 2011).

This study responds to the above claim made by IIA. Given these facts, it can be seen that the study on any aspect of internal audit outsourcing is relevant as it will contribute to new development in the field, as there is a dearth of research in the area. Kamyabi and Devi (2011) expressed concern about the urgent need for studies in internal audit outsourcing as they noted that there are only a few studies done in the area. The distress in the Nigerian banking sector and bad performance in the other sectors of the Nigerian economy form part of the reason for undertaking this study in the area of outsourcing IAFs.

Equally, the distress in the banking sector in Nigeria is said to reflect lack of effective control mechanism of the internal audit functions in the banks (Sanusi, 2003; Okafor & Ibadan, 2009; Otusanya & Lauwo, 2010). The financial crisis in Nigeria, in particular, have called for the reinforcement of the internal audit functions and the strengthening of the controls systems in the Nigerian banking sector (Okafor & Ibadin, 2009). Hammersley et al.

(2008) argued that lack of efficient and effective internal audit functions in an organization could be an indication of a significant internal control system deficiency or even a material weakness. An effective and efficient risk management and risk based supervision by banks and their regulators are heavily dependent on both the implementation of adequate internal control systems and competence of internal audit staff (Katz, 1998). Hilman and Warokka (2011) contended that the issue of in-housing versus outsourcing will remain as one of the most strategic issues for most business organizations.

Outsourcing is a strategy used by management to delegate functions or activities formerly performed inside the organization to specialized and efficient outside providers (Elmuti & Kathawala, 2000; Momme, 2001; Barac & Motubatse, 2010). Elmuti & Kathawala, (2000) state that outsourcing is a strategy that can be used by organizations to choose highly skilled and competent service providers and consequently be able to outsource activities for which they do not have critical need, or for which they lack the special capabilities to perform internally. In other words, an organization outsources the service that is either not core to it or service that cannot be carried out by its internal human resource.

For the purpose of this study, outsourcing of internal audit functions refers to the engagement of external skilled and competent service providers (public accounting firm or other management consultancy firms) to perform one or more of the internal audit functions traditionally performed in-house. The study promises to be a valuable addition to the existing wealth of literature on outsourcing of in-house managerial functions to outside service providers, with specific focus on the extent of internal audit functions outsourcing by the Nigerian deposit money banks. Towards this end, the research question set to be answered by the study is: to what extent have Nigerian Deposit Money Banks (DMBs) been outsourcing their internal audit functions?

3. Methodology

Survey research is conducted to elicit information on the extent of IAFs outsourcing by the Nigerian DMBs. The population of the study comprises of all the 22 consolidated conventional banks now addressed as Deposit Money Banks (DMBs). The list is as at 31st July, 2013.

Table 3.1: Deposit Money Banks (DMBs) in the Nigerian banking industry (Source: Adapted from Central Bank of Nigeria, 2013)

S/N	Banks	License type
1	Access Bank PLC	National
2	CITI Bank Limited	National
3	Diamond Bank PLC	National
4	ECO Bank PLC	National
5	Enterprise Bank PLC	National
6	Fidelity Bank PLC	National
7	First Bank PLC	National
8	First City Monuments Bank	National
9	Guaranty Trust Bank PLC	National
10	Heritage Bank PLC	Regional
11	Jaiz Bank PLC	Regional
12	Key Stone Bank PLC	National
13	Main Street Bank PLC	National
14	SKYE Bank PLC	National
15	Stanbic IBTC Bank	National
16	Standard Chartered Bank	National
17	Sterling Bank PLC	National
18	Union Bank PLC	National
19	United Bank for Africa PLC	National
20	Unity Bank PLC	National
21	Wema Bank PLC	Regional
22	Zenith Bank PLC	National

The population of the study is similar to the population used by Dele (2012) who examined the effect of successful outsourcing on performance of Nigerian banks. Table 3.1 shows that out of the 22 DMBs existing in Nigeria, as at 31st July, 2013, three DMBs (Heritage, Wema & Jaiz Banks) are regional banks, while all the other

19 are national banks. It also shows that four DMBs (Citi, First City Monument, Standard Chartered and Stanbic IBTC) are not quoted in the Nigerian Stock Exchange.

For the establishment of the extent to which IAFs are outsourced by the Nigerian DMBs, all the 22 Deposit Money Banks in Nigeria were surveyed. Top and middle level management staffs of the banks were administered copies of the survey questionnaire. This is because they are the establishers and custodians of the internal control system and internal audit system of the banks. Accordingly, heads of operations, branch managers, regional/area managers and internal auditors/controllers were used as respondents, especially as they have background knowledge and experience on the workings of the internal audit functions in the Nigerian banking industry. A total of five hundred and fifty (550) copies of the survey questionnaire are administered to a sample of bank officers holding the four (4) positions in the 22 DMBs in Nigeria, as shown in table 3.2 below:

Table 3.2. Questionnaire Administration

Items	Administered Questionnaire	Returned Questionnaire	Percentage of Response
Total	550	435	79%

Source: Field Survey, 2013

Table 3.2 shows that 550 copies of the questionnaire are administered (25 copies per DMB) and, as completed copies are returned, 435 (79%) are accepted for analysis, after data editing to avoid the use of incomplete responses, exaggeration of responses and other clear subjective attitudes of respondents. In the questionnaire, respondents were asked to indicate the extent to which internal audit functions (IAFs) are outsourced by their banks (completely, partially, occasionally or rarely).

Descriptive technique is employed to analyze and interpret the data captured in various tables drawn from the accepted copies of the questionnaire.

4. Results and discussion

4.1 Analysis on the Competence of the Study’s Respondents

The focus of this study is to test the extent of internal audit functions (IAF) outsourcing by the Deposit Money Banks (DMBs) in Nigeria. Towards that end, 550 top and middle level management staffs of the 22 DMBs in Nigeria, as at 31st July, 2013, were administered the questionnaire designed to elicit information on their banks’ extent of IAFs outsourcing.

To prove the competent of the selected respondents further, some demographic questions were raised which were all responded to in the 435 copies of the questionnaire accepted for analysis and interpretation. Tables 4.1A - 4.1C show the years of banking experience, ranks and educational qualifications of the respondents.

Table 4.1A. Experience

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1-5	138	31.6	31.6	31.6
	6-10	183	42.1	42.1	73.7
	>11	114	26.3	26.3	100.0
	Total	435	100.0	100.0	

Source: Field Survey, 2013

Table 4.1A shows 68% of the respondents have more than 5 years of banking experience, 26% having more than 10 years of banking experience. Even those that fall within the 1-5 years of banking experience (constituting 32%), they must have acquired a lot of experiences in a banking related organization for their banks to place them in the top or middle level position. With such length of banking experience each of the respondents has the competent to talk about the internal control system, internal audit system, the discharge of internal audit functions, and the extent of IAF outsourcing in their banks.

Table 4.1B. Rank

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Rn.Mgr	46	10.5	10.5	10.5
	Br.Mgr	137	31.6	31.6	42.1
	Opr.Mgr	80	18.4	18.4	60.5
	Int.Ctr	172	39.5	39.5	100.0
	Total	435	100.0	100.0	

Source: Field Survey, 2013

Table 4.1B is about the ranks of the respondents. It shows that 40% of them are quality/internal controllers of their banks. All other respondents are managers of operations or of regional/branch/area/zonal offices. They, therefore, are in the position to give authoritative information about the extent of IAF outsourcing in their banks.

Table4.1C. Qualification

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	PhD	11	2.6	2.6	2.6
	Masters	321	73.7	73.7	76.3
	Bachelor	103	23.7	23.7	100.0
	Total	435	100.0	100.0	

Source: Field Survey, 2013

Table 4.1C shows the highest educational qualifications of the respondents. 74% of them hold master's degrees (MBF, MBA, MTM, MPA, MSc, MA). Up to 3% hold PhD degrees. In any case, the table is a proof to the fact that the respondents are highly experienced to be part of the study in view of their high educational qualifications. In fact most of them hold professional certificates in addition to the academic qualifications, as they enjoy the membership of ICAN, ANAN, NIM, CITN, CIBN, CISON and so on. The training they must have received, in the course of obtaining the academic and professional certificates, must have exposed them to the discharge of IAF and the extent of its outsourcing in their banks.

Based on the respondents' experience in the Nigerian banking industry, positions/ranks they presently hold and their impressive educational qualifications, it is not out of place to conclude that they are eminently qualified to respond to all the questions contained in the questionnaire and to guide the study in reaching conclusions on the extent of IAF outsourcing by Nigerian DMBs.

4. 2 Extent of IAF outsourcing by Nigerian DMBs

Respondents are asked to objectively indicate the extent to which internal audit functions are outsourced in their banks, at the branch, zonal or head office levels. Fifteen (15) internal audit functions, as identified from the literature (see for examples: Dandago, 2002; Sawyer, 2003; Tanko, 2004; Sharma & Subramaniam, 2005; Cooper et al, 2006; Carey et al., 2006; Coram et al., 2008; Okafor & Ibadin, 2009; Kamyabi & Devi, 2011), are tested in this study as to the extent to which they are outsourced by the Nigerian deposit money banks.

Table 4.2 summarizes the extent to which an IAF is outsourced by the Nigerian DMBs. It shows the summarized percentage responses on the degree of outsourcing or not outsourcing of each of the 15 IAFs by the banks. Of course the percentages for "Outsourced" could be complete, partial or occasional outsourcing. Table 4.2 shows that even though all the 15 identified functions of internal audit are outsourced, some are more outsourced than others. From the table, six items: A, C, J, M, N, and O have higher responses on actual practice of outsourcing than not outsourcing of IAF by DMBs in Nigeria.

These six items are for: (i) establishing accounting system, (ii) evaluation of the system, (iii) verification of assets, (iv) recruitment of staff and other HRM activities, (v) ensuring security of documents, and (vi) ensuring security of IT database. They are the IAFs that are heavily outsourced by the Nigerian DMBs (going by the 50% and above scores they attracted from the respondents). These IAFs do not fall within the very significant and core-functions of the banks.

Table 4.2. Degrees of internal audit functions (IAFs) outsourcing

Type of IAF	Total Responses	Outsourced	Not outsourced
Establishment of Accounting System (A)	435	234(53.9%)	201(46.1%)
Monitoring/Supervision of Accounting System (B)	435	183(42.1%)	252(57.9%)
Evaluation of Accounting System (C)	435	224(51.4%)	211(48.6%)
Design of Internal Control System (D)	435	137(31.6%)	298(68.4%)
Serving as Custodian of Internal Control System (E)	435	143(32.9%)	292(67.1%)
Soundness, Adequacy & Application of ICS (F)	435	212(48.7%)	223(51.3%)
Ensuring Compli. with Est. policies, Plans & Procedures (G)	435	201(46.1%)	234(53.9%)
Examination of Financial Report before External Audit (H)	435	149(34.2%)	286(65.8%)
Economy, Efficiency & Effectiveness of Operations (I)	435	212(48.7%)	223(51.3%)
Verifying the Existence of Assets (J)	435	226(52.0%)	209(48.0%)
Conducting Special Investigations (K)	435	126(28.9%)	309(71.1%)
Detailed Test of Transaction & Balances (L)	435	120(27.7%)	315(72.3%)
Human Resource Management (M)	435	315(72.4%)	120(27.6%)
Security of documents (e.g. Audit trail) (N)	435	378(86.8%)	57(13.2%)
Security of Information Technology (IT) Database (O)	435	258(59.2%)	177(40.8%)

Source: Filed Survey, 2013

The other nine (9) IAFs are more discharged in-house than outsourced to outsider experts by the Nigerian DMBs, as per the respondents' considered opinions. This result is an empirical answer to our research question: To what extent have Nigerian Deposit Money Banks (DMBs) been outsourcing their internal audit functions?

5. Conclusion

As per the revelation from the literature, internal audit unit/department of a serious business organization is the heart of that organization, in view of the importance that should be attached to the functions the unit/department discharges. As the functions are effectively discharged, an organization is bound to be prosperous in terms of cost-effectiveness, profitability, liquidity and high degree of solvency.

It is clear from the results obtained that all the 15 IAFs are being outsourced by the Nigerian DMBs at various levels and in varying degree (at branch level, regional level, zonal level or head office level, as the case might be and at different degrees: completely, partially, occasionally or rarely). Six (6) IAFs stand out as those that are substantially outsourced by the Nigerian DMBs (going by the 50% and above scores they attracted from the respondents). The other nine (9) IAFs are found to be more discharged in-house than outsourced to outside experts by the Nigerian DMBs.

Since the study had established that the IAFs that are mostly outsourced by the Nigerian deposit money banks do not fall within the very significant and core-activities of the bank, it is recommended that a bank's management should consider the peculiarities of the bank in choosing more of the other nine IAFs that are non-core functions for at least partial outsourcing, in addition to the six most frequently outsourced IAFs in the industry. A bank may decide to partially outsource an IAF where the management wants to prevent leakage of information about its competitive advantage, proprietary information, or bank-specific technology from its competitors. The bank can maintain an in-house senior internal audit staff, for example, who will serve as the custodian of this sensitive information, whereas IAFs that might not relate to sensitive information could be outsourced to outside competent service providers, thereby avoiding the need to carry the costs of full-time internal members of staff to manage an outsourceable function. Again, this would yield a more positive effect on the banks financial performance as cost-effectiveness, profitability, liquidity and degree of solvency would increase.

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