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Internal audit function: a comparison between private and public sector in Nigeria

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Abstract. This study compares the internal audit functions between private and the public sector. Features examined include hierarchical rank of internal audit function, internal audit transfer, outsourcing of internal audit services and working relationship of internal audit with external auditor. The study is based on a survey of internal audit managers and chief internal auditors in private and public sector entities in Nigeria. The results revealed that there is no much difference in hierarchical rank of internal audit function in both sectors. While the results showed that differences exist in the reporting status between internal audit in the two sectors with private sector internal audit reporting to audit committee and chief executive officer and public sector internal audit reporting to chief executive officer and chief financial officer. Almost a similar amount of work is outsourced, and private sector entities are more likely to outsource than those in public sector. There is slight difference between internal audit activities and interaction with external auditor in the two sectors with private sector more likely to coordinate in the area of access to audit working papers.

1 Introduction

Over the past two decades, the world has witnessed a series of high profile of corporate collapses, as a result of which has led to various effort to build-up regulatory framework in order to restore investors confidence which internal audit function (IAF) is such a framework within the corporate governance. The expected benefits of strong IAF arise from the view that an effective internal controls make fraud difficult, make fraud discovery likely, provides value-added assurance services and promote effective organizational governance which could results in better financial reporting process and audit function [1]–[4]. The growing role of effective internal audit in enhancing corporate governance has been emphasized through various legislations such as: Sarbanes Oxley Act (SOX), 2002 in the USA, Corporate Law Economic Reform Program Act (CLERAP) 2004 in Australia, Corporate Laws Amendment Act, 2006 in South Africa. In Nigeria Section 61 Sub Section 1, 2 and 3 of the Investment and Securities Act (ISA), 2007 and Nigerian Securities and Exchange Commission Code of Corporate Governance, 2003 places a strong emphasis on private companies (public listed entities) to establish IAF and requires that board of directors and audit committee to evaluate and report on internal controls effectiveness.

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While Rule 1701 (2) of Financial Regulations 2009 a Federal Republic of Nigeria Official Gazette addresses the issue of IAF for public companies (Government-owned corporation, and agencies).

Based on the notion that good IAF over financial reporting is an effective corporate governance mechanism and result in higher quality financial reporting in both sectors; this study aims to examine the similarities and differences of IAF in the private sector and that of its counterpart in the public sector. The study is motivated by the growing importance on the task of IAF as a corporate governance device in both sectors and the need to have a greater understanding of IAF and their operations in Nigerian public and private and public sector entities. It has been contended that differences exists between private and public sector internal auditing in relation to their structures and operations [5]. The study extends that of [6], [7] with focus on public sector entities.

The principal interest of corporate governance stem from the separation of ownership and control in public organizations. Agency theory in this setting present the foundation for explaining the functions assigned to IAF since it is the IAF that provides assurance to the management [24]. The shareholders interest has been reinforced through the efforts of professional bodies and government which result in increased demand on the management to ensure that corporations are managed effectively. Much of this demand has been as a result of public expectations in reaction to corporate scandals. The institutional theory postulates that corporation's management and control arrangement have a tendency to go with public expectations. Thus, this study relies on both the agency and institutional theories to compare the similarities and differences between public and private sectors IAF in Nigeria.

2 Literature review

In line with a paradigm of corporate governance developed by the Institute of Internal Auditors (IIA), an effective IAF is one of the four foundations of corporate governance sideways with the management, the board of audit committees and the external auditor. Previous literature for example [8], [9] also uphold the view that IAF is an important corporate governance device that plays a significant role in organizational governance by overseeing the organizational risk, evaluating and assessing control mechanisms.

Prior researches have indicated disparity exists between public and private sector IAF [5] in a comparison of public and private sector IAF in South Africa found that internal controls in national departments are recognized to be effective corporate governance mechanisms but they are not yet well established as those in the public sector.

Studies examining the operational and organizational status of IAF shows that [10] survey the opinions of bank lending officers with regard to the influence of reporting arrangement on internal audit capabilities to avert financial statement fraud. The findings of the study established that IAF that report to senior management are seen as being less able to avert deceitful financial reporting as against those that report exclusively to audit committee.

Similarly, [11] using a case study method looked at five Belgium companies to examine the expectations and opinions of both senior management and internal auditors with regard to the association between the two groups. The study indicated that when internal audit work largely with a management support role there may be lack of perceived independence of the internal audit.

Prior studies have also shown a mixed result with regard to the decision to dismiss the chief internal auditor. For example, [12] study the association between IAF and the audit committee influence on the independence and objectivity of the internal auditors. Their result indicated that 72 percent of the audit committee members were involved in the

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dismissal of the chief internal auditor. In a similar situation, [13] reported that 52 percent of the Australian and New Zealand audit committee members are involved in the decision to dismiss the chief internal auditor.

Outsourcing of internal audit services has become prevalent in recent years. Prior studies have recognized several incentives for outsourcing internal audit services [14], [15]. A study of [16] investigates the manner and the impact of outsourcing the IAF in the United Kingdom (UK) private and public sector organizations and the impact of outsourcing decision may likely have on auditor independence and quality of audit service. The result of the study indicated that most of the organizations prefer an in-house IAF and that not all respondents are of the opinion that independence may be compromised when internal audit services are outsourced to external audit.

[15] Examine the consequence of SOX as it relates the restriction on outsourcing internal audit services to the external auditor using a sample of 219 responses from 1,000 fortune chief internal auditors. The result of the study indicated that firms with independent, active and expert audit committee are less likely to outsource routine internal audit services to external auditor

Past studies provides proof of the influence of IAF on audit fees and reliance of external auditors on IAF work ([17], [18] all this studies reported that an increased dependence on the work of the IAF by external auditor can translate into lower external audit fees. [18] Find that the use of IAF as a management training ground is positively associated with external audit fees. However, [19] reported an increased in external audit fees as a result of internal control reporting requirements of SOX.

3 Research method

Data were gathered by means of a questionnaire sent to head of internal audits of the sampled organizations. The sample comprises of both private and public sector entities in Nigeria. Private sector entities comprises of 257 listed firms out of which 80 were selected as the final sample. Public sector in Nigeria comprises of three ties of government i.e. the Federal, State and Local Government Councils. The sample in this study comprises of 40 federal public companies excluding federal ministries.

The questionnaires were mailed to 120 head of internal audits and 68 responses were received generating a response rate of 56.66 percent. There were 41 responses from the private sector organizations representing 60.29 percent and 27 responses from public sector representing 39.17 percent. The questionnaire was structure following previous studies with little modification [13], [20]–[22] each question was designed to incorporate responses expressed in multiple choices that enabled the respondents to express their opinion.

In this study, it is presumed that IAF in the private sector to be sound corporate governance device which of its features have to be in line with those of an IAF in the public sector, even though the two settings may follow contrasting contexts this remain an issue of empirical investigation.

4 Results

This section present the results of descriptive analysis performed on data collected through the survey. Table 1 presents the summary of the results from the questionnaire. From the hierarchical rank of IAF, the table shows that 36 internal audit managers in the private sector representing 88 percent indicated that the head of internal audit is located at corporate level compares to 21 respondents representing 78 percent in the public sector. This result suggests that IAF of both sectors was placed at corporate level as opposed to

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being placed at regional level or state level. This is in line with ISA 2007, SEC Code of Corporate Governance and Financial Regulation Rules of the Federal Government Official Gazette 2009. This finding corroborate with[22] that of who reported that both private and public sector entities IAF in Australia were placed at corporate level.

When asked on the average years do internal auditors stay in a unit before being transferred to another unit within the company, 19 respondents (46.34 percent) from the private sector indicated that on average internal auditors stays between 4 years in the internal audit with 12 percent indicating internal audit stays for 5-6 years. Whereas 22 respondents (81 percent) from the public sector indicated that on average internal auditors stays for more than 8 years in the IAF. A comparison with [22] study indicated that 47 percent of the respondents indicate that on average internal auditors in Australia stay for 2 and 4 years in the IAF. A similar study of [12] indicated that 37 percent (20 respondents) indicated that in IAF such a movement to other units was unlikely for internal auditors in Singapore.

Twenty-three percent of the private sector respondent indicated that audit committee (AC) members are involved in the appointment, evaluation and dismissal of the head of the IAF while 68 percent indicated that AC performs these function together with the chief executive officer (CEO). Whereas, 81.48 percent respondents of the public sector indicated that the CEO are mandated to appoint, evaluate and dismiss the head of IAF. A comparison with Canadian study of [23] reported that 48 percent of the respondents indicated that AC are involved in the dismissal of the IAF. [12] reported 72 percent in Singapore, [20] reported 50 percent of AC are involved in the appointment evaluation and dismissal of internal audit head in Australia.

The table also shows that 71 percent of the private sector IAF report to the AC and CEO while 10 percent indicated that besides AC and CEO they also report to the CEO. The table further shows that 81.5 percent of the public sector respondents indicated that IAF report to CEO while 18.5 percent shows that besides the CEO they also report to the CEO and CFO. In a similar study [22] indicated that 38 percent of the IAF report functionally to the AC, 47 percent shows that besides the AC they also report functionally to CEO and CFO whereas 32 percent of the respondents report administratively to CEO.

There is also slightly significant difference between the two sectors with regard to internal audit service outsourcing. 85.37 percent of the private sector IAF being involved in out sourcing compared to 67 percent of public sector internal audit being involved in outsourcing. Previous studies of [21] indicated that 69.41 percent of Italian firms do not outsourced internal audit services. Whereas, [13] indicated that 68 percent of public sector entities and 65 percent private sector entities engaged in outsourcing internal audit services.

The respondents of both sectors were asked to indicate which of the services were most commonly outsourced. Financial audit rank as the most frequently outsourced service with 46.34 percent of the private sector and 70.37 percent of the public sector outsourcing. Compliance audit encompasses 34.14 percent of private sector and 22.22 percent of public sector. While environmental audit, comprise of 7.32 percent of private sector outsourcing and 0 percent of that in the public sector. In a related study, [22] indicates that information technology and system rank as the most commonly outsourced service with 45 percent of all public sector outsourcing and 50 percent of private sector outsourcing whereas performance audit comprise of 7 percent of public sector outsourcing and 8 percent of that in private sector outsourcing in Australia and New Zealand.

This study also reports responses concerning the coordination of work of IAF and external auditor access to working papers. The results revealed that there is no significant difference between private sector and public sector responses. More than two third of the IAF coordinate in the areas of audit coverage with the external auditor and additionally, in both sectors external auditors have high level of access to internal audit working papers.

Table 1: Summary of the Results

	Public Sector		Private Sector	
	n	**%**	**n**	**%**
Hierarchical Rank of IAF				
Corporate level	21	78.0	36	88.0
Regional level	6	22.0	5	12.0
State level	0	0.0	0	0.0
Average Internal Auditor Stay in a Unit				
Less than 2 years	0	0.0	4	9.76
2 - 4 years	0	0.0	19	46.34
5 – 6 years	0	0.0	12	29.27
7 – 8 years	5	19.0	6	14.63
More than 8 years	22	81.0	0	0.0
IAF recruitment, training and dismissal				
AC	0	0.0	9	23.0
AC/CEO	0	0.0	28	68.0
CEO	22	81.48	3	7.0
CEO/CFO	5	18.52	1	2.0
Day-to-day Reporting				
AC	0	0.0	5	12.0
AC/CEO	0	0.0	29	71.0
CEO	22	81.5	4	10.0
CEO/CFO	5	18.5	3	7.0
Internal audit services outsourcing				
Yes	18	67.0	35	85.37
No	9	33.0	6	14.63
Internal audit services outsourced				
Compliance Audit	6	22.22	14	34.14
Financial Audit	19	70.37	19	46.34
Operational Audit	2	7.41	5	12.20
Environmental Audit	0	0.0	3	7.32
External auditor access to IAF working paper				
Yes	18	67.0	36	89.0
No	9	33.0	5	11.0

5 Conclusion

This study examine the similarities and differences of private sector IAF and that of its counterpart in the public sector using data collected from Nigeria companies. The study is based on a survey of internal audit managers and chief internal auditors in Nigeria. The results revealed that private sector IAF and its counterpart in the public sector have a higher hierarchal ranking where two-third of the internal audit managers and chief internal auditors indicated that IAF was placed at corporate level. Whereas, less than half of the respondents in the private sector indicated that internal auditors stays between 4-5 years in the IAF with more than half of the public sector respondent indicating internal auditors stays for more than 8 years in the unit.

It was also found that more than half of the private sector respondents (68 percent) indicated that both AC and CEO were involved in the appointment, evaluation and dismissal of the head of internal audit unit while 81.48 percent of the public sector indicated that CEO are mandated to appoint, evaluate and dismiss the head of the internal

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audit unit. The results also showed that 85.37 percent of private sector entities and 67 percent of public sector IAF indicated that they engaged in outsourcing of internal audit services. Whereas, financial audit financial audit risk rank as the most frequently outsourced services in both two sectors.

The study has potential implications for relevant regulating bodies in Nigeria and may find the result useful in assessing the usefulness of IAF rules as stated in the ISA 2007, SEC code of best practices 2003 and the federal government of Nigeria financial regulations rules 2009. The regulations mandated that all private sector and public sector entities to establish IAF. However, with other researchers, this study also had potential limitations which provide avenues for further research. Firstly, consistent with the general trends in questionnaire based research the limited number of respondents could be a hindrance to the generalization of the results and the study does not cover private companies (unlisted) thereby require careful interpretation of the findings. Secondly, the respondents were not asked directly and this may cause misinterpretation of response because the instrument prevents the possibility of explaining and detailing the questions and there is direct control over the actual respondents.

Finally, this study has higher lighted the issue of IAF in private and public sector entities in Nigeria. There is increasing attention towards internal auditing and that companies make different choices with respect to issues in terms of organizational structures and resource management. In the light of these future studies could address the problems of effectiveness of IAF, independence, relationship with AC and management, role of IAF in strengthening financial reporting quality, and if companies are investing increasing efforts in developing IAF. The investigation of these could reveal their actual contribution and provide relevant insights on the issue

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