



Internal Audit Functions: An Empirical Study of Public and Private Sectors in Nigeria

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Abstract: The study examines the similarities and differences between the private and public sectors internal audit functions in Nigeria. The features examined include the hierarchical position of the internal audit functions, outsourcing of internal audit activities, reporting relationship of the internal auditor, and the coordination between internal and external auditors. A survey of internal audit managers of both sectors was undertaken to establish their current practices. The results revealed that there are no much differences in the hierarchical positioning of the internal audit function in both sectors. A substantial difference was found in the reporting lines of internal auditors in both sectors. The results further showed that private sector outsources internal audit activities more than the public sector and a slight difference exists between the two sectors about the level of coordination between internal and external auditors. Finally, the result indicated that private sector experiences a reduction in external audit fees compares to its counterpart in the public sector.

Keywords: Internal Audit Function, Private Sector, Public Sector, Comparison, Nigeria.

JEL Classification: M40, M42, M49

Paper Type: Research Paper

1. INTRODUCTION

In the last few years, the roles of internal audit function (IAF) in corporate governance have established a growing interest owing to its impact on the internal control risk management system. The internal audit profession has taken advantage of this renewed interest by changing the roles and broadening the scope of internal auditor's participation in the organisational governance process and risk management control. Such

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developments have had the goals of expanding the value-adding roles of internal auditors to their organisations.

The increasing roles of internal audit function in both private and public sectors in enhancing corporate governance have been emphasised through various legislations such as the Treadway Commission (1987) and the Cadbury Report (1998). All these were among the first to call for the importance of the internal audit function for adequate internal controls. The importance of internal audit function has increased more after the financial scandals that took place during the last two decades such as Lehman Brothers, WorldCom and Enron which make policymakers more alert on the significance of improving the effectiveness of corporate governance and provided substantial proof on the need for internal audit function as an essential part of effective internal controls.

Based on the notion that good internal audit function is a useful corporate governance mechanism and could result in higher quality governance process in both private and public organisation, this study aims to examine the similarities and differences of internal audit function in the private sector and that of its counterpart in the public sector in Nigeria. Using a survey of internal audit managers of both the private and public sectors organisation in Nigeria to establish the current practices in these organisations the study found that differences exist in both internal audit operations.

The rest of the paper is structured as follows; the next section provides a brief outline of the underpinning theories upon which this study is based. The third section outlines the literature review. The fourth section states the method used, while the results of the study are reported and discussed in the fifth section. Finally, conclusions are drawn, limitations noted and further research opportunities are discussed in the sixth section.

2. LITERATURE REVIEW

According to the 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 (IIA, 2005). Previous literature for example, Paape et al. (2003), Carcello et al. (2005), Sarens (2009) and Soh and Mortinov-Bennie (2011) 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 studies have indicated the existence of disparity between public and private sectors internal audit functions (Carhill & Kincaid 1989; Goodwin 2004). Barac and Steden (2014) 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 show that James (2002) survey concerning the opinions of bank lending officers about 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 is seen as being less able to avert deceitful financial reporting as against those that report exclusively to the audit committee.

Similarly, Sarens and De Bedde (2006) using a case study method looked at five Belgium companies to examine the expectations of both senior management and internal auditors about the association between the two groups. The study indicated that when internal audit work mainly with a management support role there may be a lack of perceived independence of the internal audit.

Prior studies have also shown a mixed result about the decision to dismiss the chief internal auditor. For example, Goodwin and Yeo (2001) 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 dismissal of the chief internal auditor. In a similar situation, Goodwin (2003) 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, for example, Caplan and Kirschenheiter (2002) and Abbott et al. (2007). A study of Selim and Yannakas (2002) 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 an external audit.

Carey et al. (2006) examine the causes of internal audit outsourcing in Australian listed firms. The result of the study advocated that internal audit outsourcing is related to perceived cost saving and the technical skills of the external service supplier. Abbott et al. (2007) 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 the external auditor.

Past studies provide proof of the influence of IAF on audit fees and reliance of external auditors on IAF work (Schneider 1984; AICPA 1990; Felix et al. 2001; Gramling et al. 2004; PCAOB 2007; IFAC 2009; Prawitt et al. 2011; Messier Jr et al. 2011). Felix et al. (2001) and Gramling et al. (2004) reported that increased dependence on the work of the IAF by the external auditor could translate into lower external audit fees. Messier Jr et al. (2011) find that the use of IAF as a management training ground is positively associated with external audit fees. However, Beneish et al. (2006) and Hogan and Wilkins reported an increased in external audit fees as a result of internal control reporting requirements of SOX.

2.1 Underpinning Theories: Agency and Institutional Theory

The principal interest of corporate governance stems 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 assures the management (Adams, 1994). The shareholder's interest has been reinforced through the efforts of professional bodies and government which result in increased demand for 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 a corporation's management and control arrangement tends 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.

3. RESEARCH METHOD

To speed-up, the analysis of the result data was gathered using a questionnaire sent to the head of internal audits of the sampled organizations. The sample comprises of both private and public-sector entities in Nigeria. Private sector entities comprise of 257 listed firms out of which 80 were selected as the final sample. The public sector in Nigeria comprises three tiers of government, namely: The Federal, State and Local Government Councils. The sample in this study comprises 40 federal public companies excluding federal ministries.

The questionnaires were hand delivered and sent as an email attachment with responses being received directly and as an email attachment to the researcher. 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 representing 39.17 percent from the public sector.

The questionnaire was structured following previous studies with little modification (Goodwin 2003; Goodwin 2004; Arena & Azzone 2007; Christopher et al., 2009; Messeir et al., 2011), each question was designed to incorporate responses expressed in multiple choices that enabled the respondents to express their opinion.

4. RESULTS

This section presents the results of the statistical analysis performed on data collected through the survey.

4.1 Organizational Status of IAF

Prior studies regarding the organizational status of IAF has centred on management support, independence, day-to-day reporting, IAF budget, objectivity, recruitment, training and dismissal and hierarchical rank of IAF (DeZoort, 2000; Glascock, 2002; James 2003; Smith, 2005 Zain et al. 2006; Mihret & Yisman, 2007; Christopher et al. 2009; Ebaid, 2011). Internal audit is carried out in a setting close to management. Thus, its independence and objectivity from management are subject to question (Glascock, 2002). Leung et al. (2004) reported that majority of internal audit executives in Australian companies had reporting task to the board of directors or audit committees. Christopher et al. (2009) indicated a threat to internal audit independence when using IAF as a stepping stone to other positions having the CFO and CEO appropriating the IAF budget. Thus, Table 1 to Table 4 present the result of the organizational status of IAF of this study.

Table 1. Hierarchical Rank of IAF

Hierarchy of IAF	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Corporate level	21	78	36	88
Regional level	6	22	5	12
State level	-	-	-	-
Total	27	100	41	100

Table 1 presents the results of the percentage test determining whether the hierarchical rank of IAF differs between the private and public-sector companies. The result 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 compare to 21 respondents representing 78 percent in the public sector. This result suggests that IAF of both sectors was placed

at the corporate level as opposed to being placed at the 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.

Table 2. Average Internal Auditor Stay in a Unit

Years	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Less than 2 years	-	-	4	9.76
2 – 4 years	-	-	19	46.34
5 - 6 years	-	-	12	29.27
7 – 8 years	5	19	6	14.63
More than 8 years	22	81	-	-
Total	27	100	41	100

On the average number of years' internal auditors stay in a unit before being transferred to another unit within the company 46.34 percent from the private sector indicated an average of between 2-4 years, with 9.76 percent indicating less than 2 years. Whereas 81 percent of the respondents from the public sector indicated that on average internal auditors stays for more than 8 years in the IAF.

Table 3. IAF recruitment, training, and dismissal

IAF Recruitment, Training and Dismissal	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Audit A/C	-	-	9	23
AC/CEO	-	-	28	68
CEO	22	81.48	3	7
CEO/CFO	5	18.52	1	2
Total	27	100	41	100

Table 3 shows that 23 percent of respondents in the private sector 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 audit committee performs these functions together with the Chief Executive Officer (CEO). Also, 81.48 percent of the respondents in the public sector indicated that the CEO was mandated to appoint, evaluate and dismiss the head of IAF.

Table 4. IAF day-to-day Reporting

IAF Day to Day Reporting	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Audit A/C	-	-	5	12
AC /CEO	-	-	29	71
CEO	22	81.5	4	10
CEO/CFO	5	18.5	3	7
Total	27	100	41	100

Table 4 present the reporting relationship of the responding IAF. It shows that 71 percent of the private sector IAF report to the audit committee and CEO, while 10 percent indicates that besides the audit committee and CEO, they also report CEO. Table 4 further shows that 81.5 percent of the public-sector respondents indicated that IAF reports to CEO while 18.5 percent indicated that besides the CEO they also report to the CEO and CFO.

4.2 In Sourcing Versus Out Sourcing of Internal Audit Activities

Several studies have investigated the insourcing versus outsourcing arrangements of IAF activities. For example, Lowe et al. (1999) indicated that internal audit outsourcing has a significant negative influence on the loan officer’s opinion of auditor independence and financial statement reliability. Carey et al. (2006) reported that 45% of Australian companies had outsourced some of their internal audit activities. Similarly, Dickins and O’Reilly (2009) show that 77% of US middle-market companies have outsourced their IAF work. In a study of Arena and Azzone (2007) indicated that 69.41% of Italian companies do not outsource internal audit services. Thus table 5 and 6 present the result of IAF outsourcing of this study.

Table 5. Internal audit services outsourcing

IAF Services Outsourcing	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Yes	18	67	35	85.37
No	9	33	6	14.63
Total	27	100	41	100

Table 5 shows that there was a slight difference between the two sectors of internal audit service outsourcing. The result shows that 85.37 percent of the private sector IAF was involved in outsourcing compared to 67 percent of the public sector. With regards to the nature of internal audit services outsourced the result is presented in Table 6.

Table 6. Internal audit services outsourced

IAF Services Outsourced	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
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	-	-	3	7.32
Total	27	100	41	100

On the nature/type of audit services outsourced, the result of the study revealed that 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 was outsourced by 34.14 percent of private sector and 22.22 percent of the public sector, while environmental audit consists of 7.32 percent of private sector outsourcing and 10 percent of that in the public sector.

4.3 Internal Auditor Interaction with External Auditor

There is extensive literature on the relations between external and internal auditors. Most of the previous studies investigating the relationship between external and internal auditors centred on the extent of reliance of external auditor on the work of internal auditor and the consequences of this reliance (Maletta, 1993; Braody, 1998; Felix et al, 2001; Krishnamoorthy, 2002; Al-Twaijry, 2004; Golver et al, 2008; Suwaidan and Qasim, 2010; Prewitt et al, 2011). The results of these studies show that the reasons for this reliance are the competence of the internal auditor, objectivity, independence, and quality of work carried out. Thus, table 7 – 9 present the result of IAF interaction with the external auditor for this study.

Table 7. External and internal auditor coordination in the area of audit coverage

Coordination in the Area of Audit Coverage	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Yes	18	67	36	89
No	9	33	5	11
Total	27	100	41	100

On coordination of work of IAF and external auditor access to working papers, the results revealed that there is no much difference between private sector and public sector. More than two third of the IAF co-ordinate in the areas of audit coverage with the external auditor, and additionally, in both sectors, external auditors have a high level of access to internal audit working papers.

Table 8. External auditor access to IAF working papers

External auditor access to IAF working papers	Public Sector		Private Sector	
	Frequency	Percentage	Frequency	Percentage
Yes	16	59	33	80
No	11	41	8	20
Total	27	100	41	100

Table 8 presents an overview of external auditor access to IAF working papers. The results showed that both sectors have a high level of access to internal audit working paper. The results indicated that both sectors have a higher level of access to internal audit working papers.

Table 9. Impact of IAF on the cost of an external audit

Impact of IAF cost on external audit	Public sector		Private sector	
	Frequency	Percentage	Frequency	Percentage
Less than 10%	7	25.93	14	34.15
10 – 20 %	16	59.26	21	51.22
21 – 30 %	4	14.81	6	14.63
Total	27	100	41	100

Table 9 shows the impact of the auditor reliance on the internal audit on the cost of the external audit. In the private sectors, 51.22 percent of the respondents agreed that the cost reduction is higher between 10 to 20 percent of audit fees compared to 59.26 percent in the public sector.

5. DISCUSSION

IAF plays a critical position in corporate governance by providing a range of consulting and assurance services. To be effective, IAF should be given the right place in the organization to enable it to exercise objectivity and independence. The Institute of Internal Auditors (IIA, 2001) emphasized the significance of organizational independence and objectivity of IAF, with the head of the internal audit reporting to a level within the organization that allows the function to achieve its obligations. The study examines the similarities and differences between private sector internal audit function and that of its counterpart in the public sector.

The result of the study reveals that a large number of Nigerian public and private companies established IAF. The result of the percentage test determining whether the hierarchical rank of IAF differs between the private and public-sector companies shows that 88 percent of the private sector respondent indicated that the head of the IAF is located at corporate level compares to 78 percent in the public sector. These findings are

corroborated with those that have been documented in the prior literature. For example, Christopher et al. (2009) find that both private and public-sector entities IAF head in Australian were placed at the corporate level.

On the average number of years internal auditor stays in a unit before being transfer to another unit within the company, 46.34 percent from the private sector indicated that an average of 2-4 years with 9.76 percent indicating less than 2 years. Whereas 81 percent of the respondent from the public sector indicated that on average internal auditor stays for more than 8 years in the IAF unit. Christopher et al. (2009) reported that 47 percent of the respondents indicate that on average internal auditors in Australia stay 2 and 4 years in IAF unit. A similar study by Goodwin and Yeo, (2001) indicated that 37 percent (20 respondents) shows that in IAF such a movement to other units was unlikely for internal auditors in Singapore.

With respect to recruitment, training and dismissal of internal auditor 23 percent of respondent in the private sector indicated that audit committee (AC) members are involved in the appointment, evaluation, and dismissal of the head of IAF while 68 percent indicated that audit committee performs these functions together with the chief executive officer (CEO). Also, 81.48 percent of the respondents in the public sector indicated that the CEO is mandated to appoint, evaluate and dismiss the head of IAF. In a study conducted in Canada by Scarbrough et al. (1998), it was reported that 48 percent of the respondents shows that the audit committee was involved in the dismissal of the head of IAF. Goodwin and Yeo (2001) reported 72 percent in Singapore, whereas Goodwin, (2003) reported that 50 percent of audit committee members were involved in the appointment, evaluation, and dismissal of internal audit head in Australia.

Day-to-day reporting relationship of IAF shows that 71 percent of the private sector respondent indicated that IAF report to the audit committee and CEO while 10 percent indicated that besides audit committee and CEO they also report to the chief financial officer (CFO). The result further reveals that 81.5 percent of the public-sector respondents indicated that IAF reports to CEO while 18.5 percent indicates that besides the CEO they also report to CEO and CFO. In a similar study, Christopher et al. (2009) indicated that 38 percent of the IAF report functionally to the AC, 47 percent indicated that besides the audit committee they also report functionally to CEO and CFO whereas 32 percent of the respondents reported that IAF reports administratively to CEO.

On the nature of audit services outsourced, the result of the study shows a difference between the two sectors with regard. 85.37 percent of the private sector IAF was involved in outsourcing compared to 67 percent of the public sector. This study is inconsistent with that of Arena and Azzone (2007) which indicated that 69.41 percent of Italian companies do not outsource internal audit services. However, consistent with that of Goodwin (2004) which shows that 68 percent of public sector firms and 65 percent of private sector firms engaged in outsourcing internal audit services.

With regards to the nature of internal audit services outsourced, the result of the study revealed that 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. Compliance audit was outsourced by 34.14 percent of the private sector and 22.22 of the public sector, while environmental audit comprises of 7.32 percent of the private sector. In a related study, Christopher et al. (2009) reported information technology and system rank as the most commonly outsourced service with 45 percent of the public sector and 50 percent of private sector whereas performance audit comprises of 7 percent of the public sector and 8 percent of private sector outsourcing in Australia and New Zealand.

On the coordination of IAF and external auditor access to internal audit working papers, the results revealed that there is no much difference between the private and public sector. More than two third of the IAF coordinate in the areas of audit coverage with

the external auditor and additionally, on both sectors external auditors have a high level of access to internal audit working papers. External auditing standards inspire external auditors to lessen the amount of work they carry out by relying on the effort of internal auditors (AICPA 1990). Empirical evidence has also shown that increased reliance on the work of IAF can reduce the cost of external audit fees (Felix et al. 2001; Gramling et al. 2004; Prawitt et al. 2011).

The results of the impact of IAF on the cost of the external audit revealed that 5.22 percent of the private sector respondents agree that the cost reduction is higher between 10 -20 percent of audit fees compared to 59.26 percent in the public sector. Empirical evidence, for example, Hogan and Wikkens (2006) and Beneish et al. (2006) reported an increased in external audit fees due to IAF reporting requirements of SOX. Furthermore, Messier et al. (2011) indicated that using IAF as a management training ground influence external audit fees which they provide evidence that external auditors perceived internal auditors in an IAF used as management training ground to be less objective than internal auditors employed in an IAF not used as management training ground.

6. CONCLUSION

This study examines 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-thirds of the internal audit managers and chief internal auditors indicated that IAF was placed at the corporate level. Whereas less than half of the respondents in the private sector indicated that internal auditors stay between two to four 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 (68 percent) of the private sector respondents indicated that both the audit committee 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 is mandated to appoint, evaluate and dismiss the head of the internal 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 rank as the most frequently outsourced services in both two sectors.

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 concerning issues regarding organizational structures and resource management. In the light of these future studies could address the problems of the effectiveness of IAF, independence, relationship with the audit committee and management, the role of IAF in strengthening financial reporting quality, and if companies are investing increasing efforts in developing IAF.

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