

Effective Internal Audit as a Tool for Fraud Deterrence in Nigerian Organizations

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Abstract: The study examined the internal audit activities in some Nigerian firms. Generally internal control being an integral part of corporate governance has faced a lot of regulatory reforms due to the corporate scandals and financial crisis in the economic environment. Regulators have been faced with increased disclosure requirement. Nigeria has continually been faced with high level of financial loss due to fraudulent practices. Specifically, the study looks at internal audit, as an important aspect of internal control to examine if there is a positive and significant relationship between its effectiveness and fraud prevention. The study adopted the analytical survey method together information on internal audit activities from our sample. The population comprised of senior management and staff of internal control department of firms listed on the Nigerian stock exchange. Using judgement, 2 senior management staff and 4 staff of internal control department of firms listed on the stock exchange that are been audited by the big four audit firms were chosen for the sample. Data collection was by means of the questionnaire with response options graduated into five likert scale designed to capture information on internal audit processes in the organization. Logistic regression analysis was used to test the hypothesis and the result showed that a positive and significant relationship existed between the internal audit practices and fraud deterrence. The study provides an insight into internal audit activities in Nigerian firms. The internal audit practice in most Nigerian organizations is not commendable. Therefore we recommend a more vibrant internal audit through establishment of a vibrant internal audit department, ensuring independence of the internal audit unit, attention paid to internal auditors report and recommendation and regular evaluation of the effectiveness of the internal audit unit.

Key words: Internal audit • Internal audit function • Internal audit effectiveness

INTRODUCTION

A lot of attention has been paid to corporate governance due to the increase in corporate scandals and global financial crises [1].

Regulations have therefore demanded for increased disclosure. This disclosure requirement has in turn caused a lot of demand in the corporate governance processes [2].

Internal audit is an integral aspect of the corporate governance processes. Given its position the internal audit is well placed to provide this needed assurance [3]. In other words the role of the internal audit has become expanded within the recent corporate governance system. Before this recent expansion of role, the International Internal Audit defined the internal auditing as “an independent appraisal function established within an organization to examine and evaluate its

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activities as a service to the organization". The objective of internal audit is to assist members of the organization in the effective discharge of their responsibilities. To this and the internal auditing furnishes them with analyses, appraisals, recommendation, counsel and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost".

Today, the definition of Institute of Internal Audit has become quite different.

It defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve and organization's 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 processes.

In Nigeria, efforts have been made to improve on the corporate governance practices. Haven realized the need to align with international best practices which every country is embracing. A committee which was inaugurated by the Securities and exchange commission (SEC) in collaboration with Corporate Affairs Commission (CAC) was mandated with the task of identifying weaknesses in the current corporate governance practices and then to fashion out ways of improving it. The committees finally report centered on code of best practices in corporate governance. They also identified three key main players which are the Board of Directors, shareholders and audit committee. It is therefore left for the companies to disclose meaningful information that will aid in understanding their control processes [4, 5, 6].

According to a study by Economic and Financial Crime Commission (EFCC) and the National Bureau of statistics (NBS), crime and corruption represents a major concern for business executives in Nigeria. According to a study, more than 75% of business obstacles were as a result of crime and corruption. At the international level, the Enron corporation was criticized for failure in its internal control.

According to Nigeria Deposit Insurance Commission (NDIC) report for 2006 a total of one hundred and ninety three (193) cases of fraud and forgeries were reported in the industry while a total value of N4.83 billion naira out of which N2.77 Billion or (57%) was expected to be lost.

In the world over, it has been identified that crime and corruption are the major causes of business failures. Most organizations where fraudulent activities were identified usually filed for bankruptcy or changed their ownership structure [7, 8].

Therefore the need for a robust system of internal control which internal audit is a significant part/ aspect of cannot be over emphasized [9, 10, 11].

Objective of the Study: The objective of this study is to ascertain the effectiveness of the internal audit function in deterring fraud in Nigerian quoted companies.

Theoretical Framework: This study adopted the Agency theory just like other studies on corporate governance with the objective of solving the conflict of interest between the corporate management (agents) and the shareholders and owners of capital (principals).

The agency theory is concerned with resolving two problems that can occur in agency relationship. The first agency problem arises when the desire or goals of the principal and agent conflict and there is information asymmetry, then it will be difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify if the agent has behaved appropriately.

The second problem is the problem of risk sharing that arises when the principal and the agent have different attitudes toward risk,

In an effort to align the interest of management and shareholders, certain mechanisms of accountability are adopted such as audit committee, internal audit, ethical tone and risk management which are components of an effective internal control which provides assurance of the quality of financial reporting. The effective dominance of corporate governance research in accounting and finance by agency theory has engendered shareholders centric definitions of corporate governance for example the process of supervision and control which is intended to ensure that the company's management act's in accordance with interests of shareholders [3].

This shareholders oriented perspective has been reflected in corporate governance policy document and codes of practice such as the Cadbury report (1992) [4].

The perspectives of these documents were from the point of protecting and enhancing shareholders wealth. Internal audit which is an integral part of internal control is an important tool of accountability which tries to align the interest of the principal and the agent.

Internal Auditing Function: Traditionally, the function of the internal audit is to assess the effectiveness of the organizations internal control and to report to management on areas of the control system that needs to be strengthened. Its activities may also cover non financial areas like compliance with laws and regulation.

However, from existing literature it can be found that the role of internal auditing have well been expended over the years. Even from the definition of internal audit, it can be seen that the role of the internal audit has shifted.

Formally, internal audit could be defined as an independent, appraisal function which is established within an organization to examine and evaluate its activities as a service to the organization [9].

Now IIA has modified its definition of internal auditing. Internal auditing can now be defined as an independent objective assurance and consulting activity designed to add value and improve and organizations operation.

According to IIA, In the first definition of internal auditing, the objective was to assist members of the organization in the effective discharge of their responsibilities. Therefore internal auditing will provide detailed analyses, appraisals, recommendations, counsels and information concerning the activities reviewed. Therefore the audit objective includes ensuring effective control.

However in today's definition according to IIA, internal auditing should help an organization accomplish set objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance.

This the new definition throws a lot light on the effectiveness of three features- risk management, control and governance processed one can deduce that the ability to achieve the organizational set objective largely depend on the effectiveness of these three features .

Therefore the success of an organization largely depends on the effectiveness of its internal audit.

The IIA certainly sees the objective of the internal auditing as both supporting and strengthening of the organizations governance mechanisms and evaluative and improving the effectiveness of risk management and control [9]. This suggests that the value of internal audit as part of the governance structure is at the operational level rather than as part of the higher level oversight structure.

The need for an effective internal audit cannot be over flogged for instance, in a study by Coram, Ferguson and Moroney (2008) [5] to assess the importance of the internal audit function in detecting and self reporting fraud through misappropriation of assets within organizations, they found that organizations which had some in-house internal audit function were more effective in detecting and self reporting fraud than where the internal auditing were completely outsourced.

According to ASX (CGC 2010), The internal auditing has the responsibility to generally carry out analysis and independent appraisal of the adequacy and effectiveness of a company's risk management and I.C system.

Therefore the internal auditor plays a major role in providing both assurance and consultancy services with respect to risk management in the organization

However some studies have shown that over involvement of the internal audit in the organizations risk management processes may threaten the objectivity of the internal auditor. In a study by [6], carried out to examine the impact of internal auditors' involvement in enterprise risk management and their ability to report a breakdown in risk management procedure, they found that a high involvement of the I.A in the enterprise risk management processes impacted on the willingness of the internal audit to report a breakdown in risk procedure to the audit committee.

They also found that a strong relationship with the audit committee does not appear to affect the willingness of the internal audit to report to the audit committee.

Internal Audit Effectiveness: Even with the expanded role of internal audit, the effectiveness of internal audit to the organization will not be questioned. In a study by Nagy & Cenker (2002) [11] to find out how organizational members perceived the new role of internal audit and if a justification of the effectiveness of internal audit was required. They discovered that the organizational members (top management) did not feel any need to justify the effectiveness or role of the internal audit function.

According to Mihret and Yismaw (2007) [10], the extent to which an organizations internal audit meets its purpose of establishment is dependent on some factors which are internal audit quality, management support, organizational setting and attributes of the auditee. The ability of the internal audit to provide useful audit findings and recommendations would promote management interest in its recommendation . For an internal audit to be effective, it must receive the support in terms of resources and commitment to the implementation of its recommendation Mihret and Yismaw (2007) [10] tried to identify factor impacting on the effectiveness of the internal audit services by examining how internal audit quality, management support, organizational support, organizational setting, auditee attributes and the interplay among these factors influence internal audit effectiveness.

In their finding, they reported that management support and audit quality are very important factors influencing audit effectiveness. They also found that organizational settings (not including budgetary status of internal audit) enables effective internal audit and the attributes of the auditees are not significant enough to undermine audit effectiveness.

MATERIALS AND METHODOS

Data was obtained through questionnaires distributed to the top management and staff of the internal control department of these quoted companies being audited by the big four audit firms. These groups were preferred because they are usually well informed on the internal control processes in an organization.

Model Specification: It would be useful to have an objective model that could be used to determine the effect of internal audit on fraud prevention. Such a model could be developed based on known characteristics of fraud causes. The first type of fraud model that might come to mind is the ordinary least square model (LSM). The statistical procedure for ordinary least square model (LSM) requires that the dependent variable be either interval or ratio data. However for our application, the dependent variable(fraud) was nominal (categorical):fraud occurrence (a value of 1) or no fraud (a value of 0), hence a logistic regression model is applied.

Logistic regression is similar to LSM regression but it is specifically designed to deal with a dichotomous dependent variable such as the one we are concerned with (fraud).

It is an approach to prediction. The logistic regression model for the study is as follows.. Logistic regression model.

In π

$$1 - \pi = \beta_0 + \beta_1 x$$

$$\pi = \exp(\beta_0 + \beta_1 x)$$

$$1 + \exp(\beta_0 + \beta_1 x) = P(Y=1 / X_1, \dots, X_p)$$

where, Y = dependent variable (fraud)

X_i = independent variables (int. aud., aud. comm.,eth. Tone and risk ass.)

exp = exponential function

β_0 = Intercept

β_1 = slope

1 = constant

Because the dependent variable is not continuous, the goal of the model was to predict the likelihood that Y is equal to 1 (rather than 0) given certain values of X(internal audit).

Research Findings

Information on Internal Audit Practices:

KEY: SA ==Strongly Agree, A== agree, U == Undecided, D ==Disagree, SD ==Strongly Disagree. F == Frequency, Mean> 3=Positive Mean. Mean<3 =Negative Mean.

S/NO	ITEMS	SA		A		U		D		SD		MEANS
		F	%	F	%	F	%	F	%	F	%	
1	Information on I audit											
	Adequate and timely action is taken to correct deficiencies reported by internal audit function.	5	1.18	16	3.8	23	5.5	263	62.5	119	28.3	1.7791
2.	There is timely response to the recommendation of the independent auditors regarding I.C.	129	30.6	260	61.8	20	4.8	12	2.9			3.8954
3.	Other quasi audit functions are reported to management and affect overall control environment.	2	0.47	4	1.0	33	7.8	262	62.2	122	29.0	1.7838
4	Staffing training and specialized skills are adequate in the environment.	-		32	7.6	92	21.9	215	51.1	82	19.5	2.1733
5	There is independencies in terms of reporting and authority of I.A function.	17	4.0	44	10.5	65	15.4	188	44.7	107	25.4	2.2304
6	Auditors do not have operating activities that conflict with monitoring role.	147	34.9	208	49.4	50	11.9	12	2.9	4	1.0	4.1448
7	Internal auditors have access to board of directors and audit committee.	31	7.4	79	18.8	31	7.4	194	46.1	86	20.4	2.4513
8	Internal auditor adheres to professional standards.	111	26.4	240	57.0	66	15.7	4	1.0	-		4.0879
9	Internal audit function has recently been reviewed by external parties for quality assurance.	10	2.4	10	2.4	95	22.6	206	48.9	100	3.8	2.1068
10	The scope I.A is appropriate given the nature size and structure of the company.	8.2	19.5	246	58.4	52	12.4	38	9.0	3	0.7	3.8694
11	Scope of I.A is reviewed with senior management, BOD independent auditor .	75	17.8	173	41.1	113	26.8	84	11.4	12	2.9	3.7672
12	I.A report is directed to senior management, BOD.	28	6.65	210	49.8	30	7.12	40	9.5	121	28.74	3.0193
												2.9423

Analysis: The table above presents the descriptive statistics of the responses to questions on the internal audit process in the organization. The result from the descriptive analysis show that most firms do not adequately and timely correct the deficiencies reported by the internal audit. The frequencies and percentages (62.5% do not agree and 28.3% strongly disagree) clearly indicate this and this response is supported by the mean which is 1.7791 (less than 3.00).

Considering how organizations respond to the recommendation of the independent auditors regarding internal control, the frequencies and percentages indicate that there is timely response by the organization with 30.6% and 61.8% (Strongly agreeing and agreeing respectively). This response is confirmed by the mean which is more than 3.00 (3.8954). This is an indication that the recommendation of the independent auditors are more quickly responded to than those of the internal auditors.

Form the descriptive statistics, 29% disagree and 62.2% strongly disagree that other quasi audit function are reported to management and affect the overall control environment. The mean value is 1.7838. This is also indicative of the fact that most organization do not consider the report generated by the internal audit unit. They see it merely as a routine and adequate attention is not given to the report or recommendation they generate. Staffing, training and specialized skills in the environment from the result does not seem to be adequate. The result has a mean of 2.1733 which is less than 3. Most organizations do not seem to know the need for specialization. They do not invest in training of staff.

Considering the independence of internal auditors in terms of reporting and authority this is poor with percentages of 44.7% and 25.4% (disagreeing and strongly disagreeing) and a mean value 2.2304. In most firms internal auditors do not have access to the appropriate quarters where they should report to. Interestingly our result shows that in most firms, auditors do not have operating activities that conflict with monitoring role. This is shown with a cumulative percentage 84.8% of the firms agreeing and strongly agreeing and a mean value 4.1448. However, internal auditors access to board of directors or audit committee is on the low side with 46.1% and 20.4% disagreeing and strongly disagreeing respectively and a mean value 2.4656.

Even with an efficient internal auditing lack of access to the appropriate reporting quarters will jeopardize their effort which is evident in their adherence to professional standards with 26.4% and 57.0% strongly agreeing and agreeing respectively and the mean supporting these values at 4.0879. Item 10 shows that few firms (20%) review their internal audit for quality assurance this has a mean value of 2.1068.

However, the scope of internal audit given the nature, size and structure of the company seem to be appropriate. The result shows that 19.5% strongly agree and 58.4% agree. The mean value also supports this with a value of 3.8694. As seen from the table, internal audit scope is reviewed with senior management and the independent auditors. The cumulative percentage of strongly agree and agree is 58.9%, the mean value also shows a value of 3.7672.

6.65% and 49.8% strongly agreed and agree respectively that internal audit report is directed to senior management and the independent auditors.

However the overall mean value which is 2.9423 shows that generally the internal audit function of the firms which are quoted on the stock exchange and which are being audited by the big four audit firms is below the mean level.

Testing of the Hypothesis

Hypothesis 1:

H₀₁: An effective internal audit function is not positively and significantly related to fraud deterrence in Nigerian quoted companies.

Logistic regression analysis of Internal audit function as a predictor of fraud

Variables in the Equation									
		B	S.E.	Wald	df	Sig.	Exp(B)	95.0% C.I. for EXP(B)	
								Lower	Upper
Step	Internalau(1)	-.905	.334	7.365	1	.007	.404	.210	.778
1	Constant	1.897	.310	37.555	1	.000	6.667		

a. Variable(s) entered on step 1: Internalau.

Decision Rule: An effective internal audit function is positively and significantly related to fraud deterrence in Nigerian quoted companies (p = 0.007, OR = 0.404, C.I = 0.210 – 0.778). Effective internal audit function increases fraud by a multiplicative factor of 0.404. In other words, the more effective the internal audit function, the more fraud is reduced in the companies. Hence the null hypothesis was rejected. The logistic regression model is given as:

$$\text{Log}_e \left(\frac{\pi}{1 - \pi} \right) = B_0 + B_1 X = 1.897 - 0.905 \times \text{effective internal audit function}$$

To estimate odds per se, the equation is exponentiated:

$$\pi = e^{B_0 + B_1 X} = e^{1.897 - 0.905 \times \text{effective internal audit}}$$

$$1 - \pi$$

Finally, the probability of fraud is obtained by applying the logistic transformation:

$$\pi = \frac{e^{B_0 + B_1 X}}{1 + e^{B_0 + B_1 X}} = \frac{e^{1.897 - 0.905 \times \text{effective internal audit}}}{1 + e^{1.897 - 0.905 \times \text{effective internal audit}}}$$

RESULTS AND DISCUSSION

The result of the regression analysis shows that there is a significant positive relationship between an effective internal audit system and the fight against fraud. This finding validates the earlier finding of Coram *et al.* [5] on the effectiveness of internal audit. Coram found that having a full or partial in house internal audit function increases the likelihood of detecting and self reporting fraud.

Gramling and Myers [7] also show that an effective internal audit function can signal the presence of fraud risk, thereby helping to detect and prevent fraudulent financial reporting. In our findings we discovered that most organizations actually establish an internal control department in the organization. These departments are adequately staffed and also make effort to carry out their duties and make appropriate recommendation.

But their recommendation do not seem to go a long way as most of the time action is not initiated by the top management to correct the deficiencies they have discovered. Ironically, the recommendation of the independent auditors seems to be more quickly responded to. This may be as a result of their independence. Non adherence to their recommendation may result to qualification of their report. The internal auditors are sometimes laden with other responsibilities which in most cases conflict with their monitoring role.

According to the IIA [9], the roles of the internal auditor has evolved. It requires that the BOD and audit committee initiate additional services which it must provide. Our organizations are handicapped in this area. There is remarkable lack of communication link between the internal auditors and the highest level of management (BOD and audit committee). Mihret and Yismaw [10] have found that management support and audit quality are very important factors influencing audit effectiveness. This will greatly jeopardize internal audit function. Findings and recommendations need to be channeled to the level of management where decision could be affected by these findings. The recent corporate governance practices, requires that the audit committee should maintain a communication link with the internal audit; this will greatly increase the independence of the internal audit. The BOD and audit committee have the responsibilities to mandate the I.A to investigate any area of their choice and their report directed to them accordingly.

According to the institute of internal auditors [9] internal auditors should assist both management and the audit committee in their risk management responsibilities and oversight roles by examining evaluating, reporting and recommending improvement on the adequacy and effectiveness of management risk processes. Their usefulness cannot be over emphasized.

CONCLUSION

From our result we can say Nigerian firms have not imbibed the recent prescriptions on internal control practices. This is evident from our questionnaire responses. The resultant effect is widespread fraud.

Our business organizations have become more complex and dynamic. Therefore the management and board of directors who have been saddled with the operations and success of these organizations must ensure they maximize the shareholders fund which they have been entrusted with. They must therefore cultivate an aggressive means of ensuring that fraud and risk are brought to its barest minimum. This can only be achieved through an effective internal control system.

Recommendation: From the foregoing, there is need for organizations to ensure a more vibrant internal audit department is established in the organization.

Regulatory bodies should be more involved to ensure a more vibrant internal audit department is established and maintained.

Governance processes should ensure the internal audit is highly independent and their recommendation reviewed for implementation.

Significant attention should be paid to the independent auditors report on the assessment of the internal control processes which internal audit is a part of.

The organization should from time to time undertake an independent assessment of its internal audit to evaluate its effectiveness (according to Attribute standard 1312).

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