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# A conceptual perspective of internal audit quality and local government performance in Nigeria

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## Abstract

The study highlights the influence of internal audit quality on the performance of an organization. Internal audit quality components such as competence, quality of internal audit work, objectivity and independence, training and development, and management support for the internal audit function are critical for enhancing organizational processes. It relies on extant literature in developing the conceptual framework and arriving at hypotheses that guide the study. Thus, the study suggests that the quality of internal audit influences performance and this link opens up a new perspective in examining the local government performance in Nigeria.

**Keywords:** Internal audit, internal audit quality, local government, performance

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## 1. INTRODUCTION

Local governments worldwide are noted for being the closest to the people and are key to the development of society. Local governments are recognized as conduits through which gains of leadership filters down to the community and major developments of highly democratic societies gained credence from local governments (Schoburgh, 2012). Local governments serve to ease the conduct of government activities and ensure adequate representation of communities. Thus, it is borne out of decentralization of upper tier governance in order to reach communities (Asaju, 2010). It is estimated that 49.5 percent of the world's population live in rural areas and Africa and Asia have rural populations of 60 percent and 58 percent respectively (United Nations, 2011). In Nigeria, rural population make up 50 percent of the total estimated population of 168.8million (World Bank, 2012). This leaves the local government with an enormous task of ensuring resources are managed effectively and efficiently to maximize value for the citizens.

In Nigeria, the local government is the third tier of government established for speedy development of communities through providing essential services that other tiers of government may not efficiently undertake (Lawal & Oladunjoye, 2010). Local government provides services such as sanitation, education, community health care, security and other basic amenities that impart the lives of a community. Globally, local governments are faced with diverse issues plaguing their ability to meaningfully deliver on their mandate. The world recession of 2008 created a strain (strained resources) on the ability of local government to meet its obligations to citizens (Ammons, Smith, & Stenberg, 2012). The recession brought about political and financial pressures, fiscal stress, budget cuts, increasing challenges at providing services, rising demand for services, changes in local government employment relationships, negative perception of government and its employees, including insider threats (Hilvert & Swindell, 2013; Levine & Scorsone, 2011; Perlman, 2014). In Nigeria, local

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governments are faced with various issues militating against their performance such as severe poverty in rural areas, inadequate infrastructure and social services, limited resources (Oviasuyi, Idada, & Isiraojie, 2010), mismanagement, frivolous spending, corruption (Lawal & Oladunjoye, 2010), and are far from producing their intended outcome for community wellbeing. Olusola (2011) study of some local government councils reported a worsening dependence on upper tier government for funding as these councils were unable to generate 10 percent of their budgeted revenue. Furthermore, Human Rights Watch (2007) study of five local governments in the oil rich Rivers state revealed that, even though financial resources to these councils had more than doubled since 1999, provision of basic services are a far cry. Consequently, the present administration of local government is regarded as ineffective and inefficient and limited in delivering on its mandate to communities (Oviasuyi et al., 2010). In view of these performance failures in Nigerian local government councils, it seems the internal audit function may not be effective in providing the stakeholders with the needed assurance and value acknowledged by researchers. The function seems unable to impact organizational processes in the local governments in Nigeria. This calls to question the quality of the function in local government and its impact on performance. Therefore, this study examines the impact of internal audit quality on performance of local government in Nigeria.

## **2. LITERATURE REVIEW**

### **2.1 Public Sector Performance**

Measuring and assessing performance in the public sector has attracted diverse attention especially in the wake of the new public management paradigm. Increasingly, public sector organizations are encouraged to improve and publish information about their performance by imbibing management practices in the private sector (Hoque, 2008). In response, some public sector organizations have developed a range of indicators to assess performance as reported in literature (Pilcher, 2005). Assessing performance in the public sector is complex given that public sector goals are geared towards providing services that benefit citizens and many stakeholders as against profits for a few shareholders. Also, goals in the public sector are often ambiguous and multiple stakeholders make varying demands for services (Boschken, 1994) and hence make comparison difficult. However, assessing public sector performance should take cognizance of the institutional setting (Bevir, Rhodes, & Weller, 2003). For example, public sector organizations are influenced and subject to rules and regulations to which they must adhere to and these have far reaching influences on how performance is internalized and measured. These regulatory influences exert coercive pressures on the organization for it to survive in the institutional context (DiMaggio & Powell, 1983) so do other organizational level factors. Given the diverse group of stakeholders with divergent interests, multiple goals and objectives which could be sometimes ambiguous and conflicting, assessing organizational performance in the local government would depend on which goals, whose perspective is being studied and what dimensions to be focused on (Walker, Damanpour, & Devece, 2010).

Organizational performance in the public sector is often associated with concepts of accountability, efficiency, effectiveness, fiscal health, financial soundness, revenue autonomy, consumer satisfaction, fiscal strength, responsiveness, quality of service, financial outcome, and financial performance (Carmeli & Tishler, 2004; Gomes, Alfinito, & Albuquerque, 2013; Walker & Boyne, 2006). Given the various concepts of performance, authors tend to define the concept differently depending on their focus. Performance reflects an organization's ability to achieve set goals (Rainey & Steinbauer, 1999). These goals could be financial or non-financial or specific aspects of an organization that require improvement. Assessing performance in the public sector should have accountability as its major focus to assure stakeholders of quality management of resources that avoids waste and promotes sustainability (Boyne & Law, 1991). Furthermore, several factors influence performance of an organization. Boyne (2003) identified resources, management, regulation, markets and organization as factors influencing public sector performance. However, Gomes et al. (2013) asserts that all factors affecting performance in the public sector have not been exhausted. In view of the above, internal audit has been acknowledged as a value adding factor to an organization with potentials of providing the needed platform for enhanced organizational performance.

Also, the quality of the internal audit function is more critical to organizational performance than its mere existence as a department. This is particularly important in the Nigerian local government where the financial regulations require the setting up of the internal audit function in every government agency across the three tiers of government. However, local governments in Nigeria are yet to benefit from the value adding role of internal audit which should translate to improved organizational processes. Hence, to contribute to performance, the quality of internal audit is a necessity.

## **2.2 Internal Audit Quality**

The quality of internal audit has been acknowledged to minimize risks, improve control issues, reduce external monitoring cost, reduce earnings management, mitigate fraud risks and minimize other opportunistic behaviours within an organization (Ege, 2014; Prawitt, Smith, & Wood, 2009). However, Davidson, Goodwin-Stewart, and Kent (2005) found no evidence that the presence of internal audit could be associated with lower earnings management. Also, Ege (2014) suggest that if managers can control the quality of internal audit, they can easily engage in opportunistic behaviours without being noticed. The implication of the above is that an organization may still have an internal audit function, yet management excesses may not be curtailed especially where aspects of the function can be contained by management. Most studies on the quality of internal audit and various aspect of an organization were done in the private sector and few have delved into the subject in the Nigerian context. For example, Onatuyeh and Aniefor (2013) examined the role of effective internal audit in management and accountability of the public sector using 245 respondents of audit departments of ministries and government agencies in Edo state in Nigeria. Although their study found some evidence that effective internal audit promotes accountability, their measure of effective internal audit leaves much to be desired as no reliability or previous test of their instrument was reported. Also, analysis was merely descriptive.

In another study, Ebimobowei and Kereotu (2011) conducted a study of audit expectation gap in two southern states of Nigeria using 96 internal auditors in state ministries. Their study suggests that the widespread governance failures are a result of internal audit not performing its role. Their study ignored the quality of internal audit in arriving at their conclusion as the quality of internal audit is important both for role performance and contribution to organizational performance. Baltaci and Yilmaz (2006) acknowledged the limited number of studies on internal audit in the public sector especially at the local government level and called for more research. Furthermore a close look at internal audit quality shows the similarity of the concept with that of internal audit effectiveness. Internal audit quality has been defined variously by researchers (Bamealdred, Brandon, Messier, Rittenberg, & Stefaniak, 2013; Prawitt et al., 2009). According to the Institute of Internal Auditors (2012), measures of internal audit quality includes competence, objectivity, independence and integrity, and work performance. It has also been argued that a high quality internal audit in organizations provides more support to the audit committee and is more responsive in risk management (Spira & Page, 2003; Zaman & Sarens, 2013). These measures are important factors in internal audit playing a significant role in governance, control and risk management.

A comparison of the above components of internal audit quality with the internal audit effectiveness measures shows striking similarities in the measurement of the variables. For example, internal audit quality is seen as percentage of completed audit plan within a financial year (Zaman & Sarens, 2013), the existence of internal audit quality assurance and improvement program (Elliott, Dawson, & Edwards, 2007), internal audit compliance with standards for professional practice of internal auditing (Abdolmohammadi, 2009), external assessment of internal audit (Institute of Internal Auditors, 2011), certification and experience (Hutchinson & Zain, 2009). These measures are in line with the process, output, and outcome measures that have been used by various researchers and they are also in line with Institute of Internal Auditors (2009) internal audit performance measures. Thus, the concept of quality has been used differently depending on researchers' focus.

## **2.3 Internal Audit Quality and Performance**

The quality of internal audit function is important in how well the function performs its role in governance, control and risk management. Prawitt et al. (2009) examined the relationship between the quality of internal audit and earnings management through the responses of chief audit executives in 216 public companies in the US from 2000 to 2005. Their study found a significant negative relationship between internal audit quality and abnormal accruals. They further concluded that the quality of internal audit is important in limiting management opportunistic behaviour which affects financial reporting quality and performance information.

Also, Lin, Pizzini, Vargus, and Bardhan (2011) in their study of internal audit role in material weakness disclosure, operationalized internal audit quality based on Prawitt et al. (2009) specification and on professional guidance of the Institute of Internal Auditors (IIA) and the America Institute of Certified Public Accountants (AICPA). The study found measures of internal audit quality not to be significantly associated with the disclosure of material weaknesses. They further assert that the presence of high quality internal audit enables the resolving of issues relating to material weakness before it becomes public, thus helping produce reliable information that portrays the correct financial position of the business.

Similarly, the presence of high quality internal audit can improve financial reporting and the state of performance in the local government and curb the ability of administrators to window dress financial reports. Furthermore, Ege (2014) carried out a study to examine if internal audit quality can prevent misleading financial reporting, bribery and other unethical practices using responses from chief audit executives of 617 firms in the US. Their study reported a negative relationship between quality of internal audit and the management misconduct. This means that a high quality internal audit is capable of preventing acts that affect the performance of the organization. Similarly, given the occurrence of wide spread governance failures in the Nigerian local government, it therefore implies that the presence of a high quality internal audit can affect the performance of local government by deterring unethical practices that promote wastage of resources and other corrupt practices.

Also, internal audit quality engenders transparency through the mechanism of monitoring. However, Davidson, Goodwin-Stewart, and Kent (2005) found no such evidence that the presence of internal audit could be associated with lower earnings management. Their study used a sample of 434 quoted companies on Australian Stock Exchange and information for analysis were mainly extracted from a single year annual report of the sampled companies. Their findings suggest that having an internal audit may not deter management from engaging in acts that are detrimental to reliable financial reporting of an organization. This finding is unexpected and contrast earlier studies that have been highlighted which generally allude to the importance of internal audit quality in curbing practices that diminish organizational progress. Also, their study did not emphasize the quality of internal audit. Furthermore, internal auditors are employees and management may ignore recommendations and override controls. The quality of internal audit can therefore affect how much the function could contribute to organizational performance.

### **2.3.1 Competence and quality of work**

A study of an organization's most influential factors on the quality of information system ranked the competence of the internal auditor as paramount while independence was least (Wright & Capps III, 2012). In another study, internal audit quality was found to be significantly related to negative abnormal accruals, indicating that internal audit quality may help minimize opportunistic behaviour and reduce earnings management within an organization (Prawitt et al., 2009). Competence indicates the educational qualifications, professional certification and professional experience of internal audit staff (Zain, Subramaniam, & Stewart, 2006). The more competent the internal audit, the more likely the function can assess factors which indicate management bias or risks of opportunism and serve as safeguards to mitigate the threat (Prawitt et al., 2009). This factor is also considered when the external auditor decides to make decisions on relying on the work of internal audit (Bame-aldred et al., 2013). Competence affects the quality of work of internal auditors. Hence, the quality of output of internal auditors affects organizational processes and how the function is perceived within the organization.

### **2.3.2 Independence and objectivity**

Independence relates to internal auditors ability to undertake audits without any hindrance and in a manner that is free of all forms of bias which allows them to make right conclusions (Institute of Internal Auditors, 2012). This is achieved by the head of internal audit's unrestricted access to all aspects of the organization. Objectivity describes internal audit maintaining an attitude devoid of any form of bias. Internal auditor's independence and objectivity are crucial elements in portraying the function as effective and allows the execution of their roles in a manner that enables the organization achieve its objectives (Christopher, Sarens, & Leung, 2009). Stewart and Subramaniam (2010) summarized independence as "state of affairs" and objectivity as "state of mind" which enables the internal auditor act in an unbiased attitude in the discharge of duties (p. 330). Internal auditors in Nigerian local governments face some potential threats to their independence and objectivity especially because they are employees and their recruitment and subsequent deployment are done in line with civil service rules. The Civil Service Commission is responsible for employing and transfers and this has potential impacts on internal audit status within the organization.

Goodwin and Yeo (2001) studied the influence of internal audit use as training ground on internal audit independence and objectivity using a sample of 65 internal auditors in Singapore. Their study found the practice to be detrimental to internal audit independence and objectivity especially where an auditee could become an internal auditor's boss. Also, Arena, Arnaboldi, and Azzone (2006), in a multiple case study of six companies in Italy, found two of the six companies studied used internal audit as training ground and management sees nothing wrong. Similar findings were reported by Sarens and Beelde (2006b). In terms of transfers, a study of 34 chief audit executives in Australia found that internal audit staff was frequently transferred out to higher

positions of management and in most of the reported cases staff spent less than a year in internal audit (Christopher et al., 2009). This scenario applies to internal auditors in the of local government service commission in Nigeria as internal auditors are often transferred out to occupy other finance functions outside audit. This has severe implications on the objectivity and independence of the internal audit function as Chadwick (1995) suggest that the internal auditor may not take a firm stand on critical issues in a bid to maintain relationships that can be rewarding to his future career. Also, using internal audit function as training ground presents the function as less objective before the external auditor and limits the level of reliance on the work of the internal auditor (Messier, Reynolds, Simon, & Wood, 2011).

Furthermore, the organizational status of the chief internal auditor affects the effectiveness of the function. Although the Financial Memoranda (1999) that guides accounting related matters at the local governments in Nigeria provides for the chief internal auditor's reporting directly to the local government Chair, yet reservations have been expressed regarding internal audit independence and objectivity. Onatuyeh and Aniefor (2013) argue that internal auditors in the Nigerian public sector may not always be objective and independent because of the prescribed reporting relationship to council chairmen who are elected persons with varying interest and are subject to a wide range of interference. Van Peurseem (2004) asserts that the internal auditor tends to align with any stance in order to protect the interest of his employer and is disinclined to take an opposite action when it concerns management. This is particularly disturbing as the function is expected to be independent and objective in the discharge of its roles. The lack of independence and objectivity can affect auditees' perception effectiveness of the function, especially when issues involving management occur and internal audit is unable to take a firm stance.

### **2.3.3 Training and development**

Internal auditors regularly need to acquire and develop new skills to enable them meet up with challenges and so the support of management in terms of regular training updates to keep abreast with new developments is undeniable (Pickett, 2000). Effective organizations regularly invest on the training of employees while others see such an effort as costly with no value added (Ubeda-Garcia, Marco-Lajara, Sabater-Sempere, & Garcia-Lillo, 2010). However, the importance of training employees is echoed by researchers and practitioners and has been acknowledged as helping employees perform better in their jobs (Smith, 2013). Also, the IIA (2009) recognizes the number of hours expended in the training of internal audit staff as an index of quality of internal audit. In a survey of measures of performance of internal audit in terms of quality, emphasizes were placed on experience, training and attaining continuing professional education. By implication, avenues for training and retraining internal auditors can improve their skills and enhance their quality of work which in turn contributes to organizational performance.

One main study to have examined the relationship between internal audit training and development and internal audit effectiveness were those of Cohen and Sayag (2010). They sampled internal auditors and general managers of 108 Israeli private and public sector organizations. Their result showed no significant relations between internal audit training and development and internal audit effectiveness. They concluded that organizational and management factors were more critical in internal audit training and development. This implies that training and developing internal audit for maximum contribution to organizational performance requires the commitment of management. As acknowledged by Ege (2014) "managers intending to commit misconduct have more opportunity to do so if they also control internal audit function quality" (p. 7).

Internal audit quality can be controlled through restricting internal audit exposure to important trainings that can impact their skills and abilities. Therefore, management restriction of the training of internal auditors limits their ability to render useful contributions to performance of the organization as internal audit may miss out on recent developments that may be useful for their roles. The nature of internal audit work creates room for career plateaus as suggested by Chau (1995). Career plateaus describe a situation where an employee feels stuck in his job due to lack of motivation, poor reward systems, stress, and slow organizational progress (Chau, 1995). Thus, training and avenues for self-development of internal auditors can help minimize career plateaus. This is particularly important for an internal auditor in the Nigerian public sector especially at the local government level where internal audit career path is tied to the finance function. Training and development can enable internal audit function contribute meaningfully to performance of an organization.

### **2.3.4 Management support towards internal audit**

Management support is important for internal audit's role in governance, control and risk management as these impacts organizational processes. Low support for internal audit in the public sector was reported in a study of

internal audit function in South African public sector (Schyf, 2000). The study suggests that the perception of internal audit function in an organization depends on the support the function receives from top management, appreciation of internal audit role by other organizational participants, funding, understanding regulations governing internal audit activities, and level of overlap between internal and external audit. In summary, the organizational context where an internal auditor operates determines how effective internal audit activities would contribute to the performance of the Organization (Okike, 2004). Organizational context represents an atmosphere created by top management to portray the internal audit function as an important activity whose recommendations and suggestions are treated promptly in the overall interest of the organization. Top management support of internal audit positions the function for better effectiveness (Cohen & Sayag, 2010). Also, top management support sets the ethical tone in an organization (Schwartz, Dunfee, & Kline, 2005) and sets the stage for the internal audit function to contribute to the performance of the organization. Top management support is pervasive as it includes funding, training and development, staffing and implementation of internal audit findings and recommendations (Cohen & Sayag, 2010; Mihret & Yismaw, 2007).

### 3. CONCEPTUAL FRAMEWORK

Figure 3.1 shows the conceptual framework of internal audit quality and local government performance in Nigeria. A high quality internal audit function has potentials for improving the performance dilemma of local government councils in Nigeria.

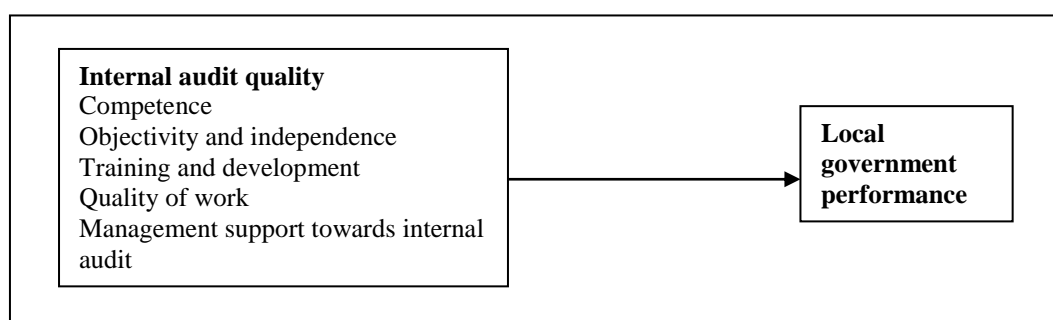


Figure 3.1: Internal audit quality and local government performance

### 4. CONCLUSION

The importance of internal audit quality to performance was highlighted through a review of literature. Components of internal audit quality include competence, objectivity and independence, career and development, quality of internal audit work and top management support of internal audit based on extant literature. From previous studies reviewed, the various components of internal audit quality contribute to improving organizational processes and performance in particular. Hence, the quality of internal audit is a necessity if organizations especially in the public sector are to harness its value adding qualities. Merely existing as a function in an organization is no guarantee that organizational processes will improve. Top management should pay attention to the quality of the internal audit function through ensuring adequate support for the function. Improved organizational processes can be translated to performance with the right quality of internal audit function. Therefore, it is important to examine the quality of internal audit on the performance of local government councils in Nigeria. A comprehensive study of local governments in Nigeria would be highly welcomed to ascertain the value adding quality of the function to ensuring achievement of goals.

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