

# Effectiveness of Internal Audit in Micro Financial Institutions: Evidence from Selected Financial Institution in Ghana

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## Abstract

The primary objective of the study is to measure the factors influencing internal audit effectiveness in savings and loans companies. Specifically, the study ascertained the suitable criteria or framework for measuring the effectiveness of the internal audit functions in micro finance institutions (MFIs). Data was obtained from three leading MFIs in Ghana. The data was collected from 30 respondents in these MFIs using structured questionnaires and in-depth interview with chief internal auditors of the MFIs. The result indicated a negative relationship between technical competence and internal audit effectiveness, no significant relationship between independence and internal audit effectiveness. The study recommends the upgrading of technical competence in audit staff through training programs to boost the effectiveness of the internal audit function.

## 1. Introduction

Over the years, the microfinance sector has thrived and evolved into its current state thanks to various financial sector policies and programmes undertaken by governments and the Bank of Ghana. The early forms of the microfinance module have evolved over the years into three major categories due to the kind of policies and programmes put in place to regulate its activities. Formal suppliers (1<sup>st</sup> tier) such as savings and loans companies, rural and community banks, as well as some development and commercial banks form the first category of the microfinance module and regulated by the Banking Act 2004 (Act 673). Asiama and Osei (2007) stated that, since the beginning of government involvement in microfinance in the 1950s, the sub-sector has operated without specific policy guidelines and goals. Despite the regulatory framework put in place by the Bank of Ghana over the years to regulate the activities of the microfinance industry, the industry could be characterised by a lot of challenges like poor internal controls. In light of this, it has become very imperative for firms in the microfinance industry especially savings and loans companies to establish proper internal audit functions. For the past decade, many savings and loans companies have come to appreciate the importance of establishing internal audit functions. In this light, savings and loans companies that have established an internal audit function operate it based on its own internal audit charter. The Institute of Internal Auditors (IIA), the international governing body for internal auditors brings some level of uniformity and consistency to internal audit functions. The Institute of Internal Auditors (IIA) provides general standards for performing internal audits and serves as a source for education and information. All internal audits in private institutions like savings and loans companies are conducted in accordance with the International Auditing Standards (IAS). The history of the IIA is closely intertwined with the establishment, growth, and evolution of the contemporary internal auditing profession. For the past sixty (60) years, the internal audit profession appears poised for continued dynamic growth and promises to become a profession for the twenty-first (21<sup>st</sup>) century. This worldwide expansion, continuing relevance and increasing influence and recognition of the IIA and the internal auditing profession over the last 60 years constitutes remarkable growth and progress. Auditing, being it external audit or internal offers an independent verification to reduce record keeping errors, asset misappropriation and fraud in business and this function of audit goes back to times scarcely less remote than that of accounting. Throughout European history, for instance, fraud cases such as the South Sea bubble of the 18<sup>th</sup> century, and the tulip scandal provided the justification for exercising more controls over managers (Ramamoorti, 2003).

As business grew in size, scope, and complexity, a critical need for a separate internal assurance function that would verify the accounting information used for decision making by management emerged. In the 20<sup>th</sup> century, the establishment of a formal internal audit function became the logical answer to many problems. It focuses initially was on the protection of the payroll against fraud, loss of cash, and other assets. This primary focus was quickly extended to the verification of almost all financial transactions. Reeve (1986), acknowledged that internal audit has gradually moved from audit for management to audit of management.

Nevertheless, the establishment of internal audit function in MFIs is not enough but internal audit functions should be effective to the extent of contributing to the achievement of the overall organisational goal. Internal auditing should not only serve basic functions of monitoring internal and financial control systems and making recommendations to management as its primary and initial focus but should be effective to contribute to the achievement of organisational profitability. Sawyer (1995) stated that internal auditor's job is not done until defects are corrected and remain corrected.

Notwithstanding the importance of internal audit effectiveness on the achievement of the objectives of MFI, the problem is how some major factors influence internal audit effectiveness and the extent to which audit

effectiveness contributes to profitability of savings and loans companies. As such this study sought to measure the factors influencing internal audit effectiveness in savings and loans companies. Specifically, to know the suitable criteria or framework for measuring the effectiveness of the internal audit functions in MFIs; to describe the internal audit functions of selected MFIs; **and** to measure the effectiveness of internal controls in savings and loans Companies.

**The study hypothesised that:**

H<sub>0</sub>: There is no positive relationship between the factors influencing internal audit and internal audit effectiveness.

H<sub>1</sub>: There is a positive relationship between the factors influencing internal audit and internal audit effectiveness.

## 2. Literature Review

### 2.1 Definition and Relevance of Internal Audit

The Institute of Internal Auditors (IIA) has provided an overarching definition of internal audit that influence the prominence of internal audit in organisation. IIA (2011) defines internal audit as "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an 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." This definition has expanded the role and responsibility of internal audit in an organisation's value creation process.

The relevance of internal audit functions in organisational setups recently cannot be overlooked. The rate of expansion of organisations coupled with the growth of complexities of internal control systems has made it imperative for organisations to establish internal audit function. Prawitt, Smith, and Wood, (2009), acknowledge the fact that as the result of the increase in accounting scandals in recent years, the internal audit functions has received impressive attention as an important contributor to effective corporate governance and financial reporting, because a high quality internal audit function focused on improving financial reporting through ensuring adherence to standards. In light of this, many research studies were conducted in the area of internal audit until the Institute of Internal Auditors (IIA) recently caused a paradigm shift in the importance of internal audit function on audit effectiveness and achievement of organisational objectives through their definition.

### 2.2 Effectiveness of Internal Audit

This new phase of internal audit functions caused a lot of research studies on the factors influencing audit effectiveness and how audit effectiveness contributes to achievement of organisational objectives, especially in the public sector. Badara and Saidin (2013), agreed to this fact stating that, the importance of internal audit in an organisational setting, especially in regard to organisational objective achievement, enable various researchers to continue to show concern over its operation.

Badara and Saidin (2013) suggest that risk management, effective internal control system, audit experience, cooperation between internal and external auditors and performance management as factors that influence internal audit effectiveness. They concluded that there is a significant effect of the factors or antecedents they proposed on internal audit effectiveness in local governments in Nigeria. Despite the fact that their studies contributed to knowledge in the area of internal audit effectiveness, their findings cannot be generalised to be the same in every organisation. Their findings are only limited to a public sector setting, that is, local government and cannot apply in a private sector setting.

Furthermore, Mihret and Yismaw, (2007) examined the effectiveness of internal audit and they developed a framework for measuring internal audit effective. The framework considers four main factors: internal audit quality, management support, organisational setting and auditee attributes. In a pure qualitative approach to their study, they concluded that, internal audit effectiveness is strongly influenced by internal audit quality and management support, whereas organisational setting and auditee attributes do not have a strong impact on audit effectiveness. The limitation identified in their study was that, the findings of the study cannot be generalised and it can only be related in a public sector setting, that is, a public sector higher institution.

Hung and Han (2013), also conducted an empirical study on the effectiveness of internal auditor in Taiwan and they produced three factors that affect internal audit effectiveness: management perception about internal audit function; factors that affect head of the auditing department's perception about internal audit effectiveness; and the last one being the factors that affect the progress of annual auditing plan. They concluded that management attitude, controller's attitude, the probability of internal auditor's promotion, the implementation of performance evaluation, the establishment of job description and the training and professional abilities of internal auditor are the factors that influence perception of internal audit effectiveness. Professional abilities of internal auditor, the combination of organisation formalization and professional abilities are the factors that influence the head of auditing department's perception about internal audit effectiveness and a combination of all these factors will also influence the progress of the annual auditing plan. The major limitation

of this study was that, some of the intended respondents to answer the questionnaires did not do it themselves. This caused bias in the answering of the questionnaires and will one way or the other affect the findings.

Another empirical study was conducted by Ramachandra, Subramanian and Kisoka, (2012). The findings was that risk management and corporate governance which are related activities of internal auditors are incorporated merely as statutory obligations and do not provide additional value to stakeholders. They also came out with findings that give a strong understanding of the agency theory, which explains the relationship between the owner and the agent by underscoring the degree of independence the internal auditors must have in Tanzanian commercial banks. They observed that the low independence of internal auditors in Tanzanian commercial banks poses a threat to the owner-agency relationship. The limitation of this study was the low response received from the Tanzanian commercial banks. They acknowledged that a wider response could have changed the findings.

Okoli, (2012) examines the role of internal audit in financial institutions in Nigeria. In her research, she ascertained the role which internal audit plays in financial institutions and how far internal audit function has contributed to the overall performance of the organisations. Analysing the data gathered from both primary and secondary sources, Okoli discovered that the internal audit department perform various functions which consist mainly of ensuring the production of accurate and reliable report, limitation of operational inefficiency on the part of workers and the prevention of misappropriation of funds. The researcher was also of the view that, if internal audit is established in financial organisation, it will contribute immensely towards the overall performance of these organisations through minimising fraud and extravagant use of funds and inducing workers to give complete and accurate information.

### 3. Methodology

The research employed the mixed approach, in which it employs the use of questionnaires and interviews as the instruments for gathering data. The data the research gathered is a cross-sectional data. The population of our studies is the eighteen (18) registered MFIs as at 2014. The target population are all registered MFIs operating in the industry for a period of ten (10) years. The sampling technique the study employed to form the sample size is the purposive sampling technique which is a non-probability sampling method. By the purposive sampling, the researcher initially selected six out of the eighteen registered MFIs which had been in operation for a maximum of ten years. Then three out of the six companies were selected based on the fact that the researcher can get the appropriate information needed for our analysis. The selection of the final three companies is judgemental. Ten (10) respondents were selected from the internal audit departments in each firm, creating a total respondents or sample size of thirty (30). In addition, three chief internal auditors in each MFIs sampled were interviewed.

Structured questionnaires were admitted to the internal auditors of the three companies. The questionnaire is a five Likert-scale-point questionnaire ranging from strongly agree to strongly disagree categorised into six sections and each section addressing specific issues.

## 4. Results and Discussions

### 4.1 Demographic Profile of Respondents

**Table 1: Office occupied by Respondents**

VARIABLES	FREQUENCY (n)	PERCENTAGE (%)
Chief Internal Auditor	3	10
Assistant Chief Internal Auditor	3	10
Audit Department Staff	24	80
<b>TOTAL</b>	<b>30</b>	<b>100</b>

**Source; Field Survey Data (April, 2015)**

In reference to the office occupied by respondents, out of the 30 respondents, 10% were Chief Internal Auditors (n=3), 10% were assistant Chief Internal Auditors (n=3) and the majority of the respondents were audit departments staff representing 80% (n=24).

**Table 2: Age of Respondents**

VARIABLES	FREQUENCY (n)	PERCENTAGE (%)
21-30	17	56.7
31-40	9	30
41-50	3	10
51-60	1	3.3
<b>TOTAL</b>	<b>30</b>	<b>100</b>

**Source: Field Survey Data (April, 2015)**

Out of the 30 respondents, majority representing 56.7% (n=17) are between the ages of 21-30 years, 30% (n=9) are between the ages of 31-40 years, 10% (n=3) are between the ages of 41-50 years and a minority

of the respondents represent 3.3% (n=1) are between the ages of 51-60 years.

**Table 3: Educational Qualification**

VARIABLES	FREQUENCY (n)	PERCENTAGE (%)
Professional qualification only	3	10
Bachelor's degree only	12	40
Professional qualification and bachelor's degree	12	40
Professional qualification and post graduate	3	10
<b>TOTAL</b>	<b>30</b>	<b>100</b>

**Source: Field Survey Data (April, 2015)**

From the table, out of the 30 respondents, 40% (n=12) have professional qualification and bachelor's degree, another 40% (n=12) have bachelor's degree only and 10% (n=3) have professional qualification only and professional qualification and post graduate. This shows majority of the internal audit staff of the savings and loans companies have professional qualification.

#### 4.2 Measurement of the Factors that Influence the Internal Audit Effectiveness.

This section describes the various factors that influence the internal audit effectiveness in the savings and loans companies. These factors include; Technical Competence, Independence of the internal auditor, the organisational setting, Management attitude towards internal audit recommendations and Rate of internal auditor's turnover.

##### *Technical Competence*

The technical competence of the internal auditor is one of the factors that influences the effectiveness of internal audit.

**Table 5: Professional qualification**

VARIABLES	FREQUENCY (n)	PERCENTAGE (%)
CA	10	33.3
ACCA	8	26.7
Others	12	40
<b>TOTAL</b>	<b>30</b>	<b>100</b>

**Source: Field Survey Data (April, 2015)**

From Table 4.5, 33.3% (n=10) have completed their CA qualification, 26.7% (n=8) have chartered with ACCA and 40% (n=12) have other professional qualifications. This means the majority of the audit department staffs are qualified chartered accountants which is an indication of their ability to understand and give appropriate responses to the questionnaire.

**Table 6: Training Opportunities**

VARIABLE	FREQUENCY (n)	PERCENTAGE (%)
Yes	30	100

**Source: Field Survey Data (April, 2015)**

Out of the 30 respondents, 100% (n=30) agree that the companies provide training opportunities for the internal audit staff. This shows that the internal audit department staff are updated and informed about new developments in the profession. Majority of the respondents also agree that these trainings take place within a period of one year.

**Table 7: Degree of Effectiveness and relevance of the trainings**

VARIABLES	FREQUENCY (n)	PERCENTAGE (%)
Effective	30	100
Relevant	30	100

**Source: Field Survey Data (April, 2015)**

From table 4.7, 100% (n=30) of the respondents agrees that trainings offered to the internal audit department staff are effective and also relevant to the internal audit work.

**Table 8: Working Qualification**

VARIABLES	FREQUENCY (n)		PERCENTAGE (%)	
	Agree	Disagree	Agree	Disagree
Internal auditors possess the required knowledge on the overall activities of the company	29	1	96.7	3.3
Internal auditors possess adequate knowledge on current internal audit practices of their profession	30	0	100	0
Internal auditor possess sufficient skills that are relevant to the performance of the internal audit function	30	0	100	0
Internal auditors use their technical expertise in the company where necessary	19	1	96.7	3.3
<b>TOTAL</b>	<b>108</b>	<b>2</b>	<b>393.4</b>	<b>6.6</b>
<b>AVERAGE</b>	<b>27</b>	<b>0.5</b>	<b>98.35</b>	<b>1.65</b>

Source: Field Survey Data (April, 2015)

In reference to table 4.8, out of the 30 respondents, 98.35% on the average agrees that internal auditors of savings and loans companies possess the adequate knowledge, sufficient skills and technical expertise in carrying out the internal audit function while 1.65% on the average also disagrees to this fact. This is an indication that, majority of internal auditors of savings and loans companies on the average exhibit adequate technical competence in executing their functions.

### 4.3 Framework for Measuring the Effectiveness of the Internal Audit

**Table 4.5: Internal Audit Effectiveness**

VARIABLES	FREQUENCY (n)		PERCENTAGE (%)	
	Relevant	Irrelevant	Relevant	Irrelevant
External auditors rely extensively on the work of the internal auditor	21	9	70	30
Internal auditor is able to achieve the set goals set by management	27	3	90	10
Internal auditor is able to detect risk associated areas in financial statements in an auditees work and make the necessary recommendations	28	2	93.4	6.6
There are structures to ensure the segregation of duties in the internal department	29	1	96.7	3.3
Recommendations made by internal auditors are relevant for decision making to management	24	6	80	20
<b>TOTAL</b>	<b>129</b>	<b>21</b>	<b>430.1</b>	<b>69.9</b>
<b>AVERAGE</b>	<b>25.8</b>	<b>4.2</b>	<b>86.02</b>	<b>13.98</b>

Source: Field Survey Data (April, 2015)

It can be noticed from the above table that, 70% (n=21) of the respondents agreed that external auditors rely extensively on the internal auditor's work and the remaining 30% (n=9) disagreed. This indicates that, majority of the respondents agree that the work done by the audit department go a long way to reduce the work by external auditors. Out of the 30 respondents, 90% (n=27) of the respondents' consent that the internal auditor is able to achieve the set goals by management whilst the other 10% (n=3) disagrees. The internal auditor is able to detect risk associated areas in financial statements in an auditees work and make the necessary recommendations by 93.4% (n=28) in agreement but 6.6% (n=2) counter-agrees. This is an indication that majority agree that the work of the internal auditor help check the accuracy of the financial statements. The result shows that there are structures to ensure the segregation of duties in the internal audit department by 96.7% (n=29) as against 3.3% (n=1). This is an indication that the staff in the internal audit department have specific duties they perform. Recommendations made by internal auditors are relevant for decision making to management by 80% (n=24) in agreement and 20% (n=6) in disagreement. This is an indication that management implements the recommendations made by the internal auditor after the audit work. An average of 86.02% (n=25.8) in total agrees that there is a suitable framework for measuring the effectiveness of internal audit but 13.98% (n=4.2) disagrees to this fact.

#### 4.4 Internal Audit Functions in MFI

**Table 4.20: Internal Audit Functions**

VARIABLES	FREQUENCY (n)		PERCENTAGE (%)	
	Agree	Disagree	Agree	Disagree
The company has an effective internal audit function	27	3	90	10
The company has a separate audit committee from internal audit department or unit	29	1	96.6	3.4
The internal audit department functions under the control of a chief auditor with a professional accountancy qualification	29	1	96.6	3.4
The internal audit department is adequately staffed in terms of number, qualifications and experience.	27	3	90	10
The internal audit department has the right of access to any unit of the company and to any document.	30	0	100	0
The internal audit department has the right to ask any information it considers necessary from any officer of the company	30	0	100	0
The company's external auditors rely on the work of the internal audit department	15	15	50	50
The company has a standard for measuring the performance of internal audit department	28	2	93.3	6.7
The company reviews its standard regularly	26	4	86.7	13.3
The company measures the performance of the internal audit department regularly	27	3	90	10
<b>TOTAL</b>	<b>268</b>	<b>32</b>	<b>893.2</b>	<b>106.8</b>
<b>AVERAGE</b>	<b>26.8</b>	<b>3.2</b>	<b>89.32</b>	<b>10.68</b>

Source: Field Survey Data (April, 2015)

90% (n=27) respondent agreed that the company has an effective audit function whilst 10% (n=3) disagreed out of the 30 respondents. The data above shows that 96.6% (n=29) respondents agreed that the company has a separate audit committee from internal audit department or unit but 3.4% (n=1) did not agree. This is an indication that there is a reporting hierarchy between internal audit department and audit committee. A respondent of 96.6% (n=29) agreed that the internal audit functions under the control of a chief auditor with a professional accountancy qualification and 3.4% (n=1) disagreed. This shows that the internal audit department is headed by a qualified auditor. From the table above, 90% (n=1) agreed that the internal audit department is adequately staffed in terms of number, qualifications and experience whilst 10% (n=3) disagreed. All respondents of 100% (n=30) agreed that the internal audit department has the right of access to any unit of the company and to any documents. 100% (n=30) respondent from the above table agreed that internal audit department has the right to ask any information it considers necessary from any officer of the company. 50% (n=15) respondent agreed that the company's external auditors rely on the work of the internal audit department. The remaining 50% (n=15) also disagreed. There is a standard for measuring the performance of internal audit department shown from the table by 93.3% (n=28) respondent whilst 6.7% (n=2) did not agree. Most respondents (86.7%, n=26) agreed that the company reviews its standards regularly but 13.3% of the respondents disagreed. It can be observed from the table above that, the company measures the performance of the internal audit department regularly based on the response from the respondent. That is, 90% (n=27) agreed and 10% (n=3) did not agree.

**Correlation Analysis between Internal Audit Effectiveness (A), Technical Competence (B) and Independence (C)**

VARIABLES	CORRELATION	(A) VARIABLE 1	(B) VARIABLE 1	(C) VARIABLE 2
<b>Internal audit effectiveness Variable 1</b>	Pearson Correlation	1	-0.037	0.208
	Sig. (2-tailed)		0.854	0.298
	N	27	27	0.27
<b>Technical competence Variable 1</b>	Pearson Correlation	-0.037	1	0.601
	Sig. (2-tailed)	0.854		0.000
	N	27	30	30
<b>Independence Variable 2</b>	Pearson Correlation	0.208	0.601	1
	Sig. (2-tailed)	0.298	0.000	
	N	27	30	30

**Source: Research Data, April, 2015)**

A correlation analysis was conducted between technical competence, independence of the internal auditor (independent variables) and internal audit effectiveness (dependent variable). From the analysis, a correlation coefficient of -0.037 was identified between technical competence and internal audit effectiveness. This implies that there is a negative positive relationship between the factors influencing internal audit (technical competence) and internal audit effectiveness. Thus, the higher the technical competence of internal auditors, the lesser they perform in terms of appraising the internal operations of an entity. This finding is however questionable sin

A correlation coefficient of 0.208 was identified, showing there is no significant relationship between factors influencing internal audit and internal audit effectiveness. This in support of the first (2nd) null hypothesis ( $H_0$ ) formed that, there is no significant relationship between the factors influencing internal audit (independence of the internal auditor) and internal audit effectiveness. This is an indication that independence of the internal auditor has no influence on the effectiveness of internal audit. This finding contradicts the finding by Ramachandra, Subramanian and Kisoka, (2012) in the work “Effectiveness of internal audit in Tanzanian Commercial banks.” In their work, they found that, the low independence of internal auditors in Tanzanian commercial banks poses a threat to the owner-agency relationship.

**5. Conclusions and Recommendations**

The aim of the study is to test the degree of influence of the factors affecting internal audit effectiveness on profitability. Technical competence and independence of the internal auditor influence internal audit effectiveness which in turn influences profitability. Questionnaires was used in gathering data from 30 respondents, 10 respondents from each company and SPSS version 16 for windows is used to analyse the data collected. The results indicate that technical competence of the internal auditor has negative influence on the effectiveness of internal audit function in savings and loans companies. From the analysis, the result shows that there is a suitable framework for measuring internal audit effectiveness, that internal controls in savings and loans companies are effective, and that there is a high degree of internal audit effectiveness on profitability.

The study recommended that MFIs should improve the technical competence of its internal audit staff by organising training programmes within specified period. MFIs should do well to maintain their internal audit staff for a longer period to increase audit experience and internal auditors turn over. The organisational setting indicates that the internal auditor is on a higher hierarchy with top level management; thus, resources should be allocated to the internal audit department to cater for more effective auditor’s work.

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