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RESEARCH ARTICLE

PERCEPTION OF EXTERNAL AUDITORS TOWARDS INTERNAL AUDIT  
PRACTICES OF PRIVATE SECTOR IN ETHIOPIA

<sup>1,\*</sup>Abraham Gebregiorgis Berhe, <sup>1</sup>Mohammed Seid Ali, <sup>2</sup>Getachew Firde Teklegiorgis

<sup>1</sup>Department of Accounting and Finance, Mekelle University, Mekelle, Ethiopia

<sup>2</sup>Department of Accounting and Finance, Wachemo University, Hossaena, Ethiopia

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ABSTRACT

The purpose of this study was to assess the perception of external auditors towards internal audit practices of private sector in Ethiopia. There were 63 audit firms registered in Federal Office of Auditor General in 2013. 140 questionnaires were distributed to external auditors from which 43 were collected. Descriptive statistics was employed to analyze the data using statistical package for social science (SPSS). The study found that independence of internal auditors was not maintained in Ethiopian private sector. Furthermore, the proficiency of internal audit function is low which negatively affects their contribution to quality audit services. It also found, internal audit functions in private sector mainly provide assurance service but, their consulting role is minimal.

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INTRODUCTION

The internal audit function has developed in many organizations to a position where it is often called upon to take leadership in helping the organization implement, assess, or conceptualize risk management and control processes within an organization. Executive bodies want the internal auditor to provide both assurance and consulting services based on broad operational skills that address risks, evaluate the efficiency of operations, and stimulate organizational action (Anderson, 2003; Anderson and Dahle, 2009; Bhasin, 2010; Mihret et al., 2010; Mihret and Admassu, 2011; Paape et al., 2003; Ramamoorti, 2003; Rossiter, 2007; Ruud, 2003; Sarens, 2009; Sarens and De Beelde, 2006). When the internal audit function is effective, it can significantly enhance the organization's potential for success (Coram et al., 2008; Hermanson and Rittenberg, 2003). The internal auditor's report should present the purpose, scope, and results of the internal audit, so that it fulfills a consulting role which affects the process of company management, the reduction of business risk, and the quality of financial and business reporting (Ljubisavljević and Jovanović, 2011). Internal auditors, by having an objective view from inside the organization, can play a vital role in the governance process by keeping management, the board, and external auditors aware of risk and control issues and by assessing the effectiveness of risk management.

Effective corporate governance requires a system of checks and balances, assuring that the right questions get asked of the right people. As result of a changing governance environment, the role of auditors is increased (Guxholli et al., 2012). Furthermore, as Guxholli et al. (2012), auditing typically operates in two capacities. First, auditors provide independent, objective assessments on the appropriateness of the organization's governance structure and the operating effectiveness of specific governance activities. Second, they act as catalysts for change, advising or advocating improvements to enhance the organization's governance structure and practices.

In study of the Imperatives of Internal Audit in Nigerian Banks, Okafor and Ibadin (2009) revealed that internal audit with an efficient internal control system positively affects corporate performance. Octavia (2011) also noted that the result of the implementation on internal audit and good corporate governance has a significant impact on company performance. Tabără and Ungureanu (2012) noted that internal auditors are integral parts of corporate governance and their expertise in control has a primary contribution in ensuring the integrity and reliability. Further, Coram et al. (2008) argue that internal audit adds value through improving the control and monitoring environment within organizations to detect fraud. Internal audit provides assurance and consulting services that help companies to achieve their objectives. Hence, the aim of

\*Corresponding author: Abraham Gebregiorgis Berhe  
Department of Accounting and Finance, Mekelle University, Mekelle, Ethiopia.

this study was to assess the perception of external auditors towards internal audit practices of private sectors in Ethiopia.

## Literature Review

Internal audit is a function of three factors that affect the organizations, namely: the proficiency of internal audit, internal audit independence, and internal audit work performance (Al-Shetwi *et al.*, 2011).

### Proficiency of Internal Audit

The internal audit needs to analyze how it can fulfill its role with its competency and capacity. Due personnel planning represents the basis for an optimal staffing of the internal audit function. Some of the personnel issues for the internal audit function, including hiring the best recruits from outside or within the organization, on the job training and professional development, and mentoring (Ruud, 2003). Internal auditors are assumed to have adequate training and experience to exercise sound professional judgment when the circumstances require so. Three components of professionalism, namely integrity, competence, and the use of due care are relevant to the internal audit profession. Objectivity with the three components of professionalism collectively is necessary and sufficient conditions for value adding assurance and consulting services (Mutchler, 2003).

Mihret (2010) reveal that technical competence, continuous training, and the scope and quality of internal audit work is an indicator of internal audit practices quality. Skilled and qualified internal audit staffs are indicative of internal audit quality (Mihret and Yismaw, 2007; Sarens, 2009). Furthermore, Fadzil *et al.* (2005) noted that when they reported that inter alia knowledge, professional certification and training lead to a lower need for monitoring of the internal control system by an internal audit function, since they are perceived as able to perform audits effectively. The audit activity must have sufficient funding relative to the size of its audit responsibilities. This important element should not be left under the control of the organization under audit because the budget impacts the audit activity's capacity to carry out its duties (Belay, 2007). Mihret *et al.* (2010), in their study of antecedents and organizational performance implication of internal audit effectiveness noted that technical competence and training are considered essential for effective internal audit practices. Thus, proficiency of the internal audit staff is an indication of good practice of internal audit function.

### Internal Audit Independence

Internal audit can be defined as method of independent and objective validation that increases the value and improves the operation and performance of organization and also facilitates the effects of related processes to achieve organization's goals and objectives (Berber *et al.*, 2012). Auditor independence and objectivity are the cornerstones of the profession. The assurance services provided by auditors derive their value and credibility from the fundamental assumptions of independence of mind and independence in appearance (Stewart and Subramaniam, 2010). Moreover, Ruud (2003) noted that to

provide the assurance services internal auditors need to be independent and objective, implying integrity, competence, due care, and ethical behavior. Therefore, multitudes of individual and organizational related factors potentially affect and are affected by internal auditors' independence and objectivity (Stewart and Subramaniam, 2010). As well, in an optimum design of corporate governance among the essential characteristics of internal audit are the independence and the objectivity (Ruud, 2003; Bostan and Grosu, 2010). Further, Ruud (2003) noted that the independence of internal auditors is a professional obligation to fulfill an objective, unbiased, unrestricted opinion, and to report matters as they are rather than as some executive would like to see them.

Brody and Lowe (2000) reveal that while it is important for internal auditors to add value to their organization, it is critical that they remain independent and objective members of the organization. Regular contacts with audit committee are important for the independence of internal audit function, as they allow internal auditors to discuss their work with independent party, which often is necessary to initiate the appropriate corrective action (Christopher *et al.*, 2009). Moreover, Mihret and Yismaw (2007) point out that independence of paramount value in providing effective internal audit service to the management, for it affords an atmosphere of objective and uninhibited appraisal and reporting of findings without influence from the units being audited; and independence of individual auditors is essential to the effectiveness of the internal audit function. Based on evidence from Singapore on the two factors affecting internal audit independence and objectivity, Goodwin and Yeo (2001) revealed that audit independence affecting the organizational independence of the internal audit function. This independence of an internal audit function in turn contributes to its quality (Barac and Staden, 2009). The literature supports the importance of an internal audit functional reporting relationship with the audit committee (Barac and Staden, 2009; Goodwin and Yeo 2001; Paape *et al.*, 2003), as it enhances the quality of an internal audit function. Yee *et al.* (2007) point out that without independence, the internal auditor simply becomes a part of the management team, losing the ability to offer a fresh perspective through an objective evaluation.

### Scope of Internal Audit Work

Internal audit role is primarily and ensure that management has reviewed its exposure to risk and insert appropriate fraud among the potential risks, giving adequately management processes such risks. Internal audit should add value to all the organization's activity, easing the identification and evaluation of the existing risks on all levels. These should be obtained by examining the essence of the risk management economical process, and operating. The internal auditors, among other, should have full definite responsibilities in preventing, identifying and signaling the frauds and should practice such actions that could create conscience (Bostan and Grosu, 2010).

## MATERIALS AND METHODS

The most important condition for differentiating among the various research strategies is to identify the type of research

question being asked (Creswell, 2003; Leedy, 1989; Yin, 1989). This study was adopted quantitative research approach to assess the perception of external auditors towards the internal audit practices of private sector.

### Sampling Methods

Self-administered questionnaire survey of external auditors' perception towards internal audit practices in private sector were undertaken to obtain the data. Attempts were made to adopt Survey cross-sectional study's using questionnaire for data collection, with the intent of generalizing from a sample to a population. There were a total of 63 private audit firms in Ethiopia, registered by the Federal Office of Auditor General as of 2013. The study selects sample from the population that satisfy its specific purposes, even if they are not fully representative (Zikmund, 2003). Contact persons were identified in the audit firms and potential respondents were then identified through the contact persons. 140 questionnaires were distributed to respondents and 43 questionnaires were filled and returned.

### Data Collection Instruments

The respondents were asked to indicate their perception at ordinal level using 5-point Likert-type scale; strongly agree (SA; or 5), agree (A; or 4), neutral (N; or 3), disagree (DA; or 2), and strongly disagree (SD; or 1). This scale is chosen so that the resulting data is suitable to statistical analysis.

### Data Analysis Method

Data analysis consists of examining, categorizing, tabulating, or otherwise recombining the evidence, to address the initial proposition of a study (Yin, 1989). The researchers were analyzed the data collected through survey to statistical population concerning the perception of external auditors towards internal audit practices of private sector in Ethiopia. The data collected via questionnaire were analyzed with descriptive statistics (mean and standard deviation) using statistical package for social scientists (SPSS).

## RESULTS AND DISCUSSION

This study was undertaken in Addis Ababa to have sufficient data from the audit firms that have experienced auditors and provide services to many companies for long period. Thus, the data were purposely collected from grade A and B audit firms. The researchers were attempted to collect data from all grade A and B (18) private audit firms. However, it was distributed 140 questionnaires to three grade A and nine grade B audit firms (or total of 12 audit firms) and collected 43 questionnaires only due to the difficulties of meeting the external auditors on their office.

### The Proficiency of Internal Audit

As indicated in Table 1, external auditors perception had a mean of less than 3.5 to all questions under the internal audit staffs' proficiency except for the growth of employees competency had mean of 3.80 and 0.96609 standard deviation. These result shows that proficiency of internal audit of companies is weak. Mihret (2010); Mihret *et al.* (2010) noted that technical competence, continuous training, and the scope and quality of internal audit work is an indicator of internal audit function quality. Skilled and qualified internal audit staffs are indicative of internal audit quality (Fadzil *et al.*, 2005; Mihret and Yismaw, 2007; Sarens, 2009). This result would lead the researchers to determine that the internal auditors need to gain adequate professional knowledge, and their skills should be continuously improved via training. The findings based on the perception of external auditors indicates that budget, training and capacity of internal audit departments are low, which reduces the internal auditors' competency and the value-adding potential of internal audit department.

### Internal Audit Independence

The results of the questionnaires distributed to external auditors regarding the internal audit independence of companies based on their most recent audit engagement, as shown in Table 2 had mean response of 3.00 and 3.0476 to questions

**Table 1. Descriptive Statistics of IA Proficiency**

	N	Minimum	Maximum	Mean	Std. Deviation
IA department is Large Enough	42	1.00	5.00	3.0476	.85404
IA obtains sufficient budget	41	2.00	5.00	3.1951	.92789
IA possess sufficient experience	41	2.00	5.00	3.3171	.93378
IA have knowledge and Skills	42	1.00	5.00	3.3333	.97946
IA has hiring Policies	41	2.00	5.00	3.1951	.87234
IA has training Policies	42	1.00	5.00	3.0952	.95788
Complete IA manual to guide	42	1.00	5.00	3.3333	1.02806
Employees competence show growth	40	2.00	5.00	3.8000	.96609
Valid N (listwise)	38				

**Note:** N- number of responses; response measurements.....5 – Strongly agree (SA), 4 – Agree (A), 3 – Neutral (N), 2 – Disagree (DA), and 1 – Strongly disagree (SD)

Source: Questionnaire Results, 2013

**Table 2. Descriptive Statistics of IA Independence**

	N	Minimum	Maximum	Mean	Std. Deviation
IA is free from Intervention	41	1.00	5.00	3.0000	1.20416
IA feels Free to include any findings	42	1.00	5.00	3.0476	1.10326
IA report to Board (Audit committee)	42	1.00	5.00	3.6905	1.15796
IA not assigned to areas they involved	39	1.00	5.00	3.4359	1.04617
Valid N (listwise)	39				

**Note:** N- number of responses; response measurements..... 5 – Strongly agree (SA), 4 – Agree (A), 3 – Neutral (N), 2 – Disagree (DA), and 1 – Strongly disagree (SD)

Source: Questionnaire Results, 2013

Table 3. Descriptive Statistics of IA Scope

	N	Minimum	Maximum	Mean	Std. Deviation
Checking adequacy of record Keeping	42	1.00	5.00	3.9762	.94966
Verify accuracy of Financial records	41	1.00	5.00	3.9756	.87999
Reviewing operating Reports	40	2.00	5.00	3.7000	.82275
Reviewing asset Safeguarding system	41	2.00	5.00	3.9268	.90527
Evaluating Internal Control system	42	2.00	5.00	3.8333	.93487
Performing audit of major fraud cases	42	1.00	5.00	3.4048	1.12747
Checking operating results efficiency	42	1.00	5.00	3.2857	1.06578
Ascertain Compliance with policies	42	1.00	5.00	3.9048	.87818
Assisting Mgt by Identifying Risk	42	1.00	5.00	3.6190	1.12515
Providing Consulting Services to Mgt	42	1.00	5.00	3.4286	1.01556
Ascertain operating objective	40	1.00	5.00	3.6000	.98189
Valid N (listwise)	39				

Note: N- number of responses; response measurements.....5 – Strongly agree (SA), 4 – Agree (A), 3 – Neutral (N), 2 – Disagree (DA), and 1 – Strongly disagree (SD)

Source: Questionnaire Results, 2013

“Internal audit is free from intervention in performing its duties and Internal auditors feel free to include any audit findings in their audit reports” with standard deviation of 1.20416 and 1.10326 respectively, which signify that internal auditors are not maintain independence. Thus, the internal audit is not effective due to independence of individual auditors is essential to the effectiveness of internal audit (Barac and Staden, 2009; Goodwin and Yeo, 2001; Mihret, 2010; Mihret and Yismaw, 2007). The external auditors' mean responses to questions “internal audit report to Board or Audit committee and internal audit not assigned to areas they involved” had 3.6905 and 3.4359. This indicates that internal auditors reporting responsibility is to board of directors (audit committees) and are not assigned to audit areas in the system design of which they participated. Thus, internal audit practices are good in relation to their reporting and tasks involved on. However, there is a deviation of external auditors' perception towards independence of internal audit function. This might be due to difference in size of companies, organizational structure, industry type and legal requirement.

As indicated in Table 3, all questions had mean responses of greater than 3.28, and the standard deviations of most responses were below 1.00, which indicates that the respondents' perceptions were close to one another. This result shows that the scope of internal audit is broad, i.e. internal auditors are involved in a range of audit assignments in the companies which audited by external auditors. These findings implies that internal audit function involvement in many activities enhance its quality as Ljubisavljević and Jovanović (2011) noted that the internal auditor's assurance and consulting role affects the process of company management, the reduction of business risk. The study also found that internal audit functions in private sector mainly provide assurance services but, their consulting role is minimal.

## Conclusion

The independence of internal auditors were not maintained and this might be undermined their roles on the quality of the services they provide. Furthermore, the internal audit functions of companies' have weak proficiency; where the budget, training and capacity of internal audit departments' were low. These findings imply that the status of internal audit function is low which negatively affects their contribution to quality audit

services. Internal audit functions in private sector mainly provide assurance service. Extensive research needs on the role of internal audit practices on company performance by taking different private sectors and by collecting data from internal auditors, management and others.

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