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## RESEARCH ARTICLE

### THE ROLE OF INTERNAL AUDIT IN PUBLIC FINANCIAL MANAGEMENT: AN ETHIOPIAN PUBLIC SECTOR CASE STUDY

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#### ABSTRACT

Government needs to be accountable in its use of public money and in providing effective, efficient, and economical service delivery. In such a desire of government in sectors financial management, internal audit plays a valuable role by providing both assurance and consulting service. Despite the fact, there are factors that affect the internal audits role in the public financial management. This study attempted to analyze internal audit function's role in the public financial management by using a case study design. Data were collected from both primary and secondary sources. The primary data were collected by interview with the internal audit director, where as secondary data were collected from rules and procedural manuals and audit reports of the function. The collected data were analyzed following qualitative approach. The findings of the study revealed that the internal audit function has limited quality. Furthermore, there is no audit committee and reporting is to the president. This might arguably affect its independence and objectivity and make the function's contribution for public financial management limited.

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#### INTRODUCTION

Public financial management encompasses different activities of the government; revenue mobilization, allocation, expenditure and accounting (Simson *et al.*, 2011). Government needs to be accountable in its use of public money and in providing effective, efficient, and economical service delivery (Van Gansberghe, 2005). Since the public money has to be used in the appropriate way, accountability is required from the government. The public needs assurance whether money is spent in the appropriate way. Hence, public sector financial management is a critical issue so as to provide the required service to the society from the government. Unless the government finance is effectively managed, it is difficult to use the finance properly to accomplish the required service. There is government concern about the proper use of fund in organizations (Coram *et al.*, 2008). In such a desire of public sectors financial management, internal audit plays vital role by providing both assurance and consulting service to the management. Internal audit is regarded as one of auditing division used as basic tool for public sector management and performance improvement in the government sector (Diamond, 2002). This role can be achieved by providing both consulting and assurance services that will help the sector to check its activity and advice in the major strategic directions.

Van Gansberghe (2005) revealed that effective internal audit function provides value adding service to organizations which in turn affected by the functions resource, organization, relations, services and procedures. In addition, Mihret and Yismaw (2007) argued that internal audit function needs to have appropriate organizational setting, internal audit quality, auditees attributes and management support to provide the required effective service. Hence, if the internal audit function possesses appropriate quality, organizational setting, auditees view towards the function and management support, it arguably improves the public financial management practice by providing assurance and consulting service. Internal audit must assist the organization in the public financial management practice (Diamond, 2002). Hence, the function can be used as a basic tool for government financial management and fraud detection. Effective internal audit function ensures effective financial management in the public sector. Though there are limitations practically, in developing and transitional countries, internal audit functions are designed to meet international standards. Thus, the ability of internal audit function to provide efficient and effective service in the public financial management can be gauged by its correspondence between the functions structure and practice with the standards (Diamond, 2002).

Despite internal audit's contribution to the public financial management practice, there are factors that hinder the functions role. According to Van Gansberghe (2005), internal audit function is highly influenced by very limited environments for internal audit with poor internal control, poorly paid and

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motivated staff, lack of an ethical organizational culture, weak governance, lack of support from senior management and limited human resources. Moreover, there may also be a lack of appropriate regulations, resources and internal audit can suffer from low status and lack of independence. This study aimed to assess internal audit function's role in providing effective service for public financial management which in turn affected by the organizational setting, the quality of the function, management support and auditees attitude towards the function by applying a case study design.

## MATERIALS AND METHODS

The research design used for the study is case study design. This design enables researchers to collect data from multiple sources and to use multiple types of data analysis (Yin, 1994). Since other federal government organizations in the country are guided by the same internal audit manual prepared by Ministry of finance and economic development, the result of this study can be generalized to other organizations having the same setting with caution. Data were collected from primary and secondary sources. The primary data were collected by interview with the internal audit director. Whereas, secondary data were collected from annual reports, rules and procedural manuals and audit reports of the university. Using data from multiple sources helps to cross validate the data. Semi structured interview with the internal audit director of the university was conducted. It allows investigators some degree of flexibility at the time of interviewing for the pursuit of unexpected line of enquiry that developed as the study progresses. Questions in the interview checklist were constructed based on the review of literature. The generalization in case study research is analytical instead of statistical and it is based on reasoning (Yin, 1994; Tellis'1997; Johansson, 2003). The data were analyzed qualitatively following inductive reasoning.

## RESULTS AND DISCUSSION

Mekelle University is regarded as one of the biggest universities in Ethiopia in terms of intake capacity. As of April 1, 2014, the university has 7 Colleges, 8 Institutes and 2 Schools. Moreover, the university hosts over 31,000 students in different programs having 1739 full-time academic staff members. This shows the need for huge amount of government budget that requires effective administration. The university's internal audit has three sub functions; financial audit function, property audit function and performance audit function. The financial audit and property audit sub functions have long existence starting from establishment of the function whereas performance audit is a new function in the department. The internal audit function has status equal to other functions. In other words, the function is positioned under the management. Too much involvement of the management in internal audit function could have negative impact on its independence (Sarens, 2009). According to Mutchler (2003), independence is described as freedom from conflict of interest. Both organizational positioning of the function and the nature of activities undertaken will dictate the set of conflicts of interest. Since internal auditors assess the work of the management, the report shall be to the independent body like audit committee.

The interview result revealed that audit report is presented to the management and copy to the ministry of finance and economic development. Hence, it is difficult for auditors to remain independent. On the other hand, internal audit manual of the function is prepared by Ministry of finance and economic development. Moreover, there are rules and procedural manuals designed by the ministry. The interview result and document review revealed that the rules and procedural manuals are regarded as clear and understandable. Having clear guideline enables the function to provide value adding service (Mihret and Yismaw, 2007). Budget adequacy is very important, because, this is a good opportunity for the internal audit function to perform its activity effectively and efficiently. Interview result revealed that the budget allocated to the function is enough to perform the activities. However, internal audit functions not only need an adequate budget, they must be able to attract and retain skilled people. The issue of attracting qualified staff can sometimes be a more challenging problem than budgetary constraint (IIARF, 2004).

Currently, the function has 15 auditors in number. With regard to the staffing procedure, though the internal audit manual says the function can clearly specify the qualifications of the staff needed, it is not applicable in the case study. Currently, human resource department restructured and shifted individuals having degree in accounting and related fields to the internal audit function from other functions by giving only short term training. This may affect the functions competency in providing value adding service in the public financial management practice. Audit quality is a function of staff experience, reasonableness of the audit scope, and effective planning and execution and communication of internal audits (IIA, 1999). The interview result showed that the function is in a difficult situation to attract skilled man power. Most of the auditors are shifted from other departments in the name of restructuring and auditors are not interested to join the function. This is mainly because of low pay rate for internal auditors. Internal audit quality is confirmed by the offices ability to provide reliable audit findings and recommendation. Lack of competent staff affects the quality of audit work (Mihret and Yismaw, 2007) and in turn limits the role of internal audit function on public financial management.

The financial audit team is formed by considering the educational background of individuals; mainly accounting and finance graduates. The audit activity is performed based on risk based plan and management request. The plan is simply checked by the supervisor sent by the ministry of finance and economic development. This may arguable affect the effectiveness of audit planning and intern the quality of audit work in general. IIARF (2004) stated that auditees do not always perceive the role of internal audit positively and it can require great skill and diplomacy to obtain their cooperation on audits. The interview result revealed that the management gives low emphasis for internal audit function. The result further revealed that both the management and auditees consider internal audit function as fault finder rather than a value adding service provider. Furthermore, auditors believe that the management gives more emphasis to the finance function than the internal audit function. Moreover, the management considers the internal audit function as a function

established as a mandatory unit by the government rather than a value adding function for the management. This might limit the management's commitment to strengthen the function and auditees cooperation at the time of field work. The existence and interaction with the audit committee enable to identify problems in the internal audit function and improve the function (Arena and Azzone, 2011). In addition, Endaya and Hanefah (2013) argued that the existence of audit committee enhance internal audit independence and reduce senior management interference in the internal audit function. Moreover, the existence of audit committee can arguably increases the possibility of implementations of the internal audit recommendations. Despite the fact, there is no audit committee in the university. Audit committee can strengthen the position of internal audit function by increasing the objectivity of auditors (Muqattash, 2013). This could limit the internal audit functions improvement and arguably affect the functions independence and objectivity. The interview result revealed that the function issues report quarterly and send to the ministry of finance and economic development. The ministry then writes a letter to the president to request action for internal audit report and recommendations. The review of audit report shows that there is a detailed report with recommendation. Internal audit reporting will have value when only the internal audit report is implemented by the management (Mihret and Yismaw, 2007). In this case study, the communication is not tight and there is no close follow-up of implementations of audit findings. This could arguably affect the value adding role of internal audit function in the financial management of the university.

## Conclusion

The findings of the study revealed that internal audit function is positioned under the management. Besides, the function quarterly present audit report to the president and copy to the ministry of finance and economic development. Hence, the independence of the function is questionable. Furthermore, internal audit unit is composed of staff assigned by the human resources department at the result of the university's restructuring. In addition function faces difficulty to attract qualified personnel because of low pay rate. Therefore, there is low staff competency in the internal audit function. Belay (2007) stated that the internal audit function might be less effective due to lack of resource, poor leadership for internal audit function, absence of appropriate frame work to measure internal audit function performance and lack of competent personnel. Furthermore, Mihret and Yismaw (2007) argued that the effectiveness of internal audit function influenced by the organizational setting, internal audit quality, management support and auditee attribute. The findings show that there is limited staff competency and the independence and objectivity of auditors is arguably questionable. Hence, the contribution of internal audit function in the public financial management is limited. Thus, the function needs to improve the staff competency by improving the benefit package. Moreover, there must be audit committee that can closely evaluate and suggest the function's improvement.

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