

## EFFECT OF INTERNAL AUDIT PRACTICES ON FINANCIAL MANAGEMENT

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### ABSTRACT

Internal audit practice is a basis for effective public institution financial management and it is important for assuming effective and efficient application of appropriate controls. The research aimed at assessing the effectiveness of internal audit practice on financial management. A descriptive cross-sectional research design was used to analyze the research problem. Questionnaire and interview guide were used to gather primary data from audit staff, account staff and heads of institution across different campuses in one of the universities in Ghana. Data were analyzed with descriptive statistics binary logistics regression framework. The study reveals that the financial performance of internal auditors regarding the mandated guidance in the university is very great as indicated by 58.8% of the respondents. Internal auditors in the university have relevant qualification and experience to influence financial performance. In addition, the independence of internal audit function and management assistance were identified as significant determinants of financial performance in the university. Challenges including inadequate staff, accommodation, and lack of office space are currently facing internal audit in the university. Finally, management implementation of internal audit recommendation has been found not to be effective. The study concluded that there are effective internal audit practices necessary for influencing financial performance. The challenges associated with internal audit practices limits the extent to which financial performance could be improved. It is recommended that management of the university should focus on recruitment of internal auditors for the various faculties than upgrading the existing ones.

**Keywords:** Auditing, independence, financial performance.

### INTRODUCTION

The rational for financial responsibility and accountability have been in the existence ever since it became necessary for an individual to assign the trust of his or her management of resources or institution to one another person or group of individuals to manage. In both public and private sectors, the suppliers of financial or business resources are normally different from those managing the institutions or businesses. The management of the organisations or businesses are tasked by the owners to report on financial performance of the organisations or institutions. Conversely, it is very cumbersome to monitor managers' actions and information asymmetry between the managers and owners of institutions which

results into the “agency problem” relating to the stewardship of institutions (Iain and Stuart, 2000). Agency theory, which is derived from financial economics literature is a part of the positivist group of theories (Adams, 1994). It maintains that a firm is made up of a nexus of agreement between the providers of resources (principals) and managers (agents) who are responsible for utilising for an economic, efficient and effective use of resources under their care. Again, it is of the view that managers possess more and detailed information than owners and that they would employ effective and efficient means to increase their capital or resources (Adams, 1994).

The public sector embodies a owner-manager (principal-agent relationship). The public officers must periodically report to the stakeholders for their performance in regard to the management of resources and the level to which the objectives of the stakeholders have been attained. The stakeholders have no belief in the performance reports that are provided by the management of public organisations and therefore demand for independent report. The principals are required to ensure that third party authenticate the integrity of financial reporting, compliance and financial performance reports. The stakeholders rely upon the independent person (auditor) to provide an independent, and objective assurance on the true and fair view of the financial reporting or performance reports by public officers and also to give an opinion on whether the resources entrusted to them have been utilized in accordance with the stakeholders’ interest. In conclusion, the functions of audit portray as an important monitoring strategy of public financial management and increasingly as an activity for the improvement of public institution financial management.

Auditing today encompasses a wide range of activities, which have different set of objectives. Traditionally, it has been a control mechanism to provide assurance that the government officials or its ministries (internal audit) and the established legislature (external audit), that public funds are received and used in accordance with the required appropriate and established relevant laws and regulations (compliance audit) and that the government financial performance reports are true and fair and they are prepared from the underlying financial records and represents its financial position (financial audit). According to (Diamond, 2002), “The audit function has involved in many countries to take a more comprehensive view of the economic and social implication of government operations often termed as “value for money” or performance audit”.

Internal audit practice/activity is a bedrock for effective public institutions financial management and it is imperative to ensure effective and efficient operations and the appropriate application of controls. It assesses compliance with underlying financial regulations, directives and measures, appraises the efficiency of adopted internal controls; evaluates the value and usefulness with which resources are utilised; evaluates the dependency and credibility of records maintenance and reporting; examines abnormalities; guarantees that resources are brought together and reported and authenticates inventory records and their identity with physical inventory (INTOSAL, 2001). The Internal audit practice is value added if it achieves its objectives by improving the organization regarding to governance, risk management and internal controls. The work of internal auditor is not complete until irregularities are rectified and remain rectified (Sawyer, 1995). Van Gansberghe (2005) posits that the effectiveness of internal audit in the public institutions should be measured on the basis of their contribution to the effectiveness and efficiency of service delivery, which in turn propels for improved internal audit service. Centre for Democracy and Development (CDD) of Ghana (2000), “asserted that government officials misuse and misappropriate public funds particularly at the local government level and this

however led to huge government budget deficit, high poverty level and poor economic performance”.

Chepkorir (2010) noted that internal audit assists an institutions accomplish their objectives by putting in place an orderly, controlled approach to review and enhance the effectiveness of risk management, control and governance processes. The internal audit activity assesses risk exposures with respect to the enterprise’s governance, operations and information systems. The internal auditors are supposed to provide recommendations for enhancement in those areas where opportunities or weaknesses are identified. Dawuda (2010) studied the “effectiveness of internal audit units in the public sector in promoting good corporate governance”. Appiah (2012) also undertook a study on the “internal audit control practices in the eastern regional hospital Koforidua”.

Conversely , the 2008-2009 global economic crises (Credit crunch) has weakened the above all, lessened the credibility of the internal audit units in advancing good corporate governance. Public sector in all countries is characterised with misappropriation of funds and corruption resulting from feeble internal control system(Van Gansberghe, 2005). Report from Centre for Democracy and Development (CDD) of Ghana (2000), “suggest that government officials misappropriate public funds especially at the local government budget deficit, low standard of living, and poor economic performance” The emerging question that one could ask is, are internal audit practices effective in organizations in this current situation since they are key component of the internal control systems established in every organization or institution?. Hence, the motivation of the researchers in assessing the effectiveness of internal audit practices on financial management in the university. This research will be different from the above mentioned researchers (Chepkorir, 2010; Dawuda, 2010; Appiah, 2012) as it will specifically look at the internal auditing practices in promoting financial management systems in a public university in Ghana. The above researchers (Chepkorir, 2010; Dawuda, 2010; Appiah, 2012) concentrated on management of risks, corporate governance and control practices but not on financial management, thus creating a research gap. This study looks at the internal audit practices on financial management in the university, the role they play in the institution, internal audit and financial assets management and how the impact on financial management, find out the basic financial management control systems and practices in universities and their effects on financial performance and find out the degree to which internal audit recommendations are executed by management.

## **2. THEORETICAL REVIEW AND CONCEPTUALISATION**

### **2.1 Determinants of Internal Audit and Financial Management**

Support from management for internal audit unit work is one of the essential factors that determines the extent to which the unit can carry out its activity and achieve the set audit objectives. The top management commitment and support is very necessary and fundamental for the effective internal audit practices. Management support canbe demonstratedfor internal audit by emphasizing the role of the internal audit unit in providing independent and objective assurance by identifying thrust areas that needs improvement in performance quality and also by implementation of the internal audit recommendations.

Management can also support internal audit unit by providing the necessary resources needed by the unit in order to perform its mandated activities. On serious note, internal audit practice is seen as very important as management permits to carry out its mandated activities. When audit reports are issued and found to be very vital to the certain sectors of the institutions and

management refuse to take far-sighted measures for political reasons, this would in turn, weaken the internal audit practice and undermines its effectiveness (Gray and Manson, 2000). According to Mihret and Yismaw (2007) “management failure to execute recommendations of internal audit has far reaching consequences on the auditor’s attitude towards enhancing audit quality, their commitment to develop a career as internal auditors”. This is also in agreement with the view of Van Gansberghe (2005), “who accepts that the execution of audit recommendation is highly essential to internal audit effectiveness”. According to Mihret and Yismaw (2007), “also added that audit findings and recommendations would not serve much purpose unless management is devoted to execute them”. The findings of the above studies shown that people would appreciate internal audit profession to be very attractive to them and even those who accept and practice internal audit may not perform their duties with high professionalism if they do not see the value added to the overall achievement of an organizational objectives in relation to corporate governance, risk management and controls. Adams (1994) “used agency theory to explicate that it is in the interest of management to maintain a strong internal audit department”. While there is a extent of continuing communication between internal auditors and management, internal auditors should not be controlled by the top management and must not be any manipulation by the management to undermine the audit outcomes”.

### **Internal Audit Standards**

Glazer and Jaenike (1980) “were of the different opinion that performing auditing assignment with respect to the internal auditing standards contributes greatly to the effectiveness of internal auditing”. Redley and D’Silva (1997) “established in the UK that conforming to professional standards is the most significant contributor to IA’s added value”. Audits standards and other services relating to audit are documented by the IIA(2008) and include; attribute standards, performance standards and implementation standards. In general, current auditing standards recognise that, internal auditors also provide services regarding risk management, corporaporate governance other than financial reports. The standards require auditors to implement their assigned and mandated responsibilities in accordance with the code of ethnics of the profession. The standards required auditors to carry out their mandated responsibilities in compliance with the code of ethics of the audit profession. In the performance of internal audit activity in relation to the required criteria for professional practice, the internal audit activity will obviously evaluate and add value to the improvement of risk management, corporate governance and control by the use of a systematic and disciplined approach. According to ( Bou-Raad, 2000), “this is very important not only for compliance with legal requirements but because the scope of auditor’s responsibilities could involve the evaluation of areas in which a high level of judgement is to be adhered to and audit reports may have a direct effect on the decisions or the course of action adopted by management”. It can be consequently argued that better quality of internal audit work-understood in relation to compliance with prescribed standards as well as a high level of efficiency in the audit’s planning and implementation stages- will improve the audit’s effectiveness in financial management.

### **Internal Controls**

Controls audits are planned to ensure that appropriate controls over systems and software are in place to ensure that internal controls and internal checks are functioning as designed. (Haylas and Ashton, 1982). Controls audits can have characteristics found into them to guaratee that falsified transactions are frown upon or made cumbersome, if not impractical to perform. Controls audits present assurance that controls are functioning but they do not essentially identify fraud or corruption. Internal controls audit goals relay to organisation’s

plans, methods and procedures used to achieve the corporate's mission, objectives and goals. Internal control also known as management controls includes planning, organising, directing and controlling programme operations and the systems put in place to measure, report and monitor programme performance (Esmajee, 1993).

Haylas and Ashton (1982) in their attempt to offer evidence on the effectiveness of particular audit performances in identifying defects undermine the financial statements recommended that all that all calculated errors are focussed in relatively few audits and these are fairly predictable by industry. The significant part of such defects influence income but the course of influence may either be an understatement or overstatement. In relation to the signalling of an error, they indicated that the significant part of financial statements errors are primarily signalled by less rigorous audit procedures such as critical review and discussions with the client. Client personnel challenges like inexperience, ineffectiveness and inadequate knowledge and insufficient control follow up or reviews were found influential in causing the errors.

Salih (1983) "assessed the internal controls of Ethiopian Airlines in Nairobi branch and conceded that the lack of segregation of accounting and custodian functions was greatest weakness of the branch office. He asserted that there is need to centralise cash receipts, establish an audit unit, separate accounting unit from sales section, separate duties of purchase activities and establish a perpetual inventory system for the tickets. He further emphasised that the existence of control is very vital especially under today's condition with severe competition which place lack of segregation of accounting and custodian functions was the greatest weakness of the branch office. He argued that there is need to centralize cash receipts, establish an audit unit, separate accounting unit from sales section, separate duties of purchase activities and establish a perpetual inventory system for the tickets. He further emphasized that the existence of control is very crucial especially under today's condition with severe competition which place premium on reliable customers' services, on consideration of cash on realisation of capital assets and manpower and on other reduction costs".

Esmajee (1993) studied the internal controls of Nyayo Bus Service Corporation- a state corporation. He learnt that cash receipts as well as cash disbursements bear moderately strong controls attributed to the fact that the government accounting system is still in process. However, the payroll and stores accounting systems had a lot to be desired. Regarding the Organizational chart, a lot of information was missing. The internal auditor was being underutilized as he was given responsibility to perform routine controls checks which were also carried out by the examination section. This resulted to replication of efforts and undermining the internal auditor's effective role.

### **Independence of Internal Audit**

According to Chun (1997), "independence is the core of auditing. This entails that, an internal auditor ought to be independent of both the personnel and operational activities of an organisation. Otherwise, the veracity of auditor's opinions, conclusions and pragmatic recommendations would be suspect. This means that independence is very critical and essential for the effective accomplishment of the function and objective of internal audit. This independence is basically obtained mainly from two features-organisational status and objectivity".



Internal audit practices in organization/institution must be objective and impartial, explaining that it should perform its activity free of doubts and interference. Members of the internal audit team may not take part in the selection and implementation of internal control systems in financial management in organization/institution. The professional competence, as well as internal motivation and systematic continue professional development of each internal auditor are important factors for the effective and efficient implementation of the internal audit department or unit of every organisation. It is also instructive to relvove individual auditors in the framework of the department, so that the routine performance of work activities is avoided. The chief internal audit executive should be responsible that the depart executes its activities in accordance with the due principles and code of the profession. The professional competences of the department staff must always be ensured by ensuring that staff attends continue professional development programmes. The internal audit department is accountable to the institution's management, and its board of directors, possibly to the audit committee. These units or organs of the organization or institution should largely be informed as to the progress of the audit plan and the performance of the internal audit department or unit objectives.

### **3 Methodology of Research**

This chapter sets out various stages and phases that were used in conducting the study. It entails the outline for the collection, measurement and the analysis of data. Specifically, the population, the sample and sampling technique, data instrumetation and the analysis of the data instruments are dealt with in this section.

#### **3.2 Research design**

The study employed descriptive approach. This design was adopted because it is appropriate (Mugenda and Mugenda,2003) for gathering data and depicts the characteristics of the population. It is also concerned with relationships and practices that exist, beliefs and processes that are ongoing, effects that are felt, or trends that are developing, hence appropriate for the study. The objective in a descriptive study is to learn who, when, where and how of a phenomenon.

#### **3.3 Population**

The target population is estimated at 60 of internal audit staff, finance staff, principal and heads of department/unit in the University. The composition of the respondents enables the researchers to gather reliable and comprehesive information from different sections of people who are responsible for ensuring the effectiveness of internal auditing practices in advancig effective financial management. Respondents' views were considered to serve as a fair representation of the true population, hence making it possible to generalise the findings of the study.

#### **3.4 Sample size and sampling procedure**

The sampled population consisted of all the internal audit staff, finance office staff and the principal and heads of departments/units including the central administration of the University. The study selected 40 Staff members from (Audit, Finance, Principal and HoDs) from a targeted population of all the staff of the campuses in the university. The staffs were selected in terms of the size of the campus as follows: campus A 15, Central Administration 10, campus B 5, campus C 5 and campus D 5. The data were treated on the basis of applicability of the study, relevance and accuracy, sufficient, cost of acquisition of the data and time contribute greatly in supporting the overall data collection. The study purposively selected senior members in the audit unit, finance unit and principal and HoDs from the

campuses thus a sample of 40 respondents. The researchers used simple random sampling to select finance staff and the principal and heads of departments/units and used census for the internal audit staff. The list of the finance staff and heads of department/units were obtained from the personnel department of the University. The researchers wrote the names of the finance staff and heads of departments/units on the pieces of papers, folded and mixed them in a container. The respondents were then made to pick one folded paper at a time independently and at random without looking through the container and recorded it until the required number of the finance staff and heads of departments/units was ascertained. The selection was done without replacement. The researchers visited all the four campuses to administer the questionnaires to the finance staff and the heads of departments/units. With respect to the internal audit staff of the university, the researchers chose all the 17 staff members of the internal audit unit of the University.

### **3.5 Data collection instruments**

Questionnaires and structured interviews were the data instruments used to gather data from respondents. Together, they provide a wealthy source of thorough information and ensure validation of the findings. This study adopted questionnaire developed by Belay(2007). It has been modified to take into an account the internal audit professional standards on the effectiveness of internal audit provided by the Institute of Internal Auditors(2009). The researcher administered a survey questionnaire made up of closed-ended and open-ended questions to each member of the target population. The interview was designed for only the internal auditor and the finance officer at central administration and it was structured in line with the questionnaire items. The rationale behind this interview was to test the responses of the internal audit staff and finance staff and to also collect detailed data that were not captured in the questionnaire items.

### **4. Results and Discussion**

This chapter outlines the results of major findings of the study which is to help inform decisions with respect to the effectiveness of internal auditing on the financial management performance of the University.

The study was conducted on the effect of internal audit practices on financial management in a University in Ghana. The results of the background information of respondents revealed that majority (90.0%) of the respondents were males while only 10.0% were females. They have different levels of educational achievement consisting of Bachelor's degree, professional certificates, masters degree and PhD.

The study pointed out that the performance of internal auditors with respect to the mandated guidance in the university is very great as indicated by 58.8% of the respondents. No respondent rated their performance below moderate. Internal auditors were noted to have been working in line with their mandated guidance. They have a good perception of the mandated guidance because it's standardized their practices and hence improved their performance. In the area of financial performance, the respondents strongly agreed that internal auditors are able to detect fraud, misappropriation of funds, and continuously improving their proficiency in relation to adding value to financial management in the university.

Among the internal auditors, 41.2% have working experience for 2-5 years, the same proportion have working experience for 6-10 years and 17.6% have work experience for over 10 years. Their work experiences are related to their profession as auditing. The various

current ranks held by the internal auditors are: internal auditor (5.9%), deputy internal auditor (5.9%), senior assistant internal auditor (29.3%), assistant internal auditor (11.8%), principal auditing assistant (11.8%) and senior auditing assistant (35.3%). The results also indicated that internal auditors in university have met the required qualities as an internal auditor. Most respondents indicate that the auditors are competent, objective, demonstrate professionalism, independent attitude of the mind, exercise of good judgement, and confidentiality. Other respondents consisting of principals of the institutions and account officers confirmed that the experience and qualification of internal auditors are above average or at least average.

Majority of the respondents either agreed or strongly agreed on some indicators of financial control systems and performance. The effect of internal control on financial management was considered to be very great by 40.0% of the respondents. Besides, 20.0% indicated that the effect of financial control system on financial management is great. Only 10.0% rated the effect of internal control system on financial management as poor. The internal audit standard and the independence of internal audit function were considered as very important financial management. Respondents indicated that these two issues have to a great extent, an influence on financial management. The results also point out that management support for internal auditors is very important in financial management. Respondents confirmed that such support should cover job satisfaction and security, unrestricted access to records, quality leadership, regular in-service training, rotation of audit staff, granting auditors the opportunity to take part in decision making. A regression results confirmed that the independence of internal audit and management support are significant determinants of financial performance in university. Factors that make internal audit unit effective include: adequate resources, allocating internal audit staff for each faculty, and organizing workshop for internal auditors.

Internal auditors are currently facing some challenges. The dominant one outline in this study are inadequate staff, lack of accommodation for internal audit staff, limited funds for internal auditor to execute their duties, lack of office space for internal auditors and the non implementation of internal audit recommendations.

It was found out that 27.5% of the sample population indicated that the recommendations of internal auditor are always executed by management. Besides, 60.0% indicated that management sometimes implements the recommendations of internal auditors. However, the remaining 12.5% stated otherwise (not implemented at all).

## **6. CONCLUSION**

The study provided mixed findings in many of the issues investigated on since responses from audit staff, account officers and heads of the various institutions sometimes vary. However, consideration is given to the views of majority of respondents. The practices of internal auditors in university are in line with the mandated guidance. This implies that technical, they are executing their required duties and the necessary conditions for their performance have been met. The fact that internal auditors have the required qualification an experience implies that, the university will need more auditors than upgrading of existing ones. It also implies that any shortfall associated with the function of internal auditors is due to lack of qualification or experience. Factors influencing internal audit function may be varied. However, the most sensitive ones are independence of internal audit unit, and management support. Factors that make internal audit unit effective include: adequate



resources, allocating internal audit for each faculty, and organizing workshop for internal auditors. These factors issues are the felt needs of internal auditors but lack management support. Despite the efforts of internal auditors, some of their reports are not given attention by management. This limits the extent to which their efforts could influence financial performance of the organization.

## 7. LIMITATIONS AND RECOMMENDATIONS

In spite of the outcomes of this study that supported the objectives, we cite a number of limitations that lead us to recommending the need to for further research. First, the survey was conducted in only one of the universities in Ghana and its satellite campuses, therefore based on the sample size selected and the regional distribution of the population is concerned, the questions will be whether the findings can be generalized. Such generalisations calls for further detailed studies with larger samples. In a strict term, the findings relate only to the respondents and generalities to larger university communities in Ghana should be done with caution. The sample size was not large enough but was enough and appropriate for the type of analysis undertaken. Secondly, this study was restricted to a single university, nonetheless the university are many. It will be interesting to analyse how the results may differ when done in all the universities.

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