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RESEARCH ARTICLE

THE ROLE OF INTERNAL AUDIT ON TRANSPARENCY AND FINANCIAL REPORTING QUALITY:  
EXTERNAL AUDITORS' PERSPECTIVE

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ABSTRACT

The intent of the study was to assess the external auditors view towards the role of internal audit function on financial reporting quality and transparency in Ethiopia. From the total of 63 private audit firms in Ethiopia, registered in Federal Office of Auditor General as of 2013, 12 audit firms located in Addis Ababa were selected purposively based on their grade. 140 Self administered questionnaires were distributed to employees (auditors) in the selected audit firms. To analyze the collected data, descriptive data analysis method was employed. The findings of the study revealed that based on the external auditors' view, internal audit function has considerable effect on financial reporting quality by detecting fraud and insuring integrity and reliability of financial statements. Furthermore, auditors believe that the internal audit function improves transparency in organizations.

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INTRODUCTION

The internal audit function (IAF, hereafter) has become a major support function for management, the audit committee, the board of directors, the external auditors, and other key stakeholders in the present business environment. When properly designed and implemented, the IAF can play a key role in promoting and supporting effective organizational governance (Bhasin, 2010; Hermanson and Rittenberg, 2003; Ruud, 2003; Sarens, 2009). Hence, IAF has wide range of contributions to the effectiveness of organizations. 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). This will enable the higher management to take corrective actions based on the internal auditors' recommendations. 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. Furthermore, as Guxholli *et al.* (2012) revealed 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. From the wide range of activities that the IAF provides, financial reporting quality and transparency are among them. These roles of IAF can be determined by the effectiveness of the function. Apart from this, external auditors, as stake holders of the IAF relays on the work of internal audit. Reliability of financial reports has far reaching effect in the economy as a whole. The existing literature provides evidence that IAF has positive effects on financial reporting oversight and reliability (Barua *et al.*, 2010; Coram *et al.*, 2008; Holt and DeZoortan, 2009; Tabără and Ungureanu, 2012). The role of IAF in improving financial reporting quality is premised on the assumption that developments in legal and accounting systems are important factors that help enhance the quality of governance process and FRQ (Al-Shetwi *et al.*, 2011).

Moreover, a key element of good governance is transparency which incorporates a system of checks and balances between key players: board of directors, senior level management, auditors and other stakeholders (Bhasin, 2010). The corporate governance reforms in many countries now give increasing importance to IAF to improve transparency and quality of financial reports. In their study conducted in the case of Saudi Arabia, Al-Shetwi *et al.* (2011) noted that corporate governance regulation is among a set of regulations adopted in recent years to enhance the efficiency of the capital market. Moreover, they reveal that IAF is an important function that provides a pioneer role in governance quality. According to Guxholli *et al.* (2012), internal auditors analyze the level of reporting transparency among parts of the governance structure. Furthermore, Julien and Rieger (2011) stated that

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internal audit understands concern for disclosure and transparency, aligning risk assessment with stakeholder expectations; addresses disclosure and transparency objectives; and understands the breadth and depth that is, the spectrum of disclosure and transparency possibilities and where the organization strives to be or should be on the spectrum. Hence, IAF plays a great role in organizations transparency. The IAF has evolved 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. Management wants the internal auditor to provide both assurance and consulting based on broad operational skills that address risks, evaluate the efficiency of operations, and stimulate organizational action. Besides, IAF is a critical part of the governance structure (Anderson, 2003; Anderson and Dahle, 2009; Bhasin, 2010; Coram *et al.*, 2008; Hermanson and Rittenberg, 2003; Mihret *et al.*, 2010; Mihret and Admassu, 2011; Ramamoorti 2003; Rossiter, 2007; Ruud, 2003; Sarens, 2009; Sarens and De Beelde, 2006). When the IAF is effective, it can significantly enhance the organization's potential for success (Coram *et al.*, 2008; Hermanson and Rittenberg, 2003).

Organizations commonly report financial results and information to key stakeholders and increasingly are reporting more than financial results. Communicating an organization's values regarding stewardship, management practices, employee relations, and other topics often shows an organization's culture and tone (Guxholli *et al.*, 2012). Besides, the transparency of financial and non-financial disclosures to stakeholders is a key element of governance (Bhasin, 2010; Bostan and Grosu, 2010; Guxholli *et al.*, 2012). In these activities, IAF is arguably significant. Furthermore, documented evidence indicates that IAF has a significant impact on FRQ in terms of detecting and preventing fraud (Coram *et al.*, 2008). Supplementary, Tabără and Ungureanu (2012) revealed that internal auditors are integral parts of corporate governance and their expertise in control has a primary contribution in ensuring the integrity and reliability of financial statements. IAF is an important function that provides a pioneer role in governance quality in general and FRQ in particular. However, the study of Al-Shetwi *et al.* (2011) noted that weak association between IAF quality and FRQ of Saudi companies listed in the Saudi stock exchange in 2009, excluding banks. Internal auditing is important in supporting and interacting with the audit committee to ensure the integrity and quality of financial reporting (Barua *et al.*, 2010). Internal audit adds value through improving the control and monitoring environment within organizations to detect fraud.

Auditors regard the existence of an IAF as an indication that directors and management are committed to strong corporate governance (Goodwin & Seow, 2002). Sound governance by board of directors is recognized to influence the quality of financial reporting (Levitt, 1998 and 2000a cited in Goodwin and Seow, 2002). IAF contributes a lot to the quality of financial reports and transparency in the organization. External auditors, as stakeholders, rely on the work of internal auditors. This will be arguably determined by the external auditors' perception towards IAF. If external auditors believe that IAF is effective and contribute to the FRQ and transparency, it affects

their audit procedure and the audit evidence required. Hence, the function of internal audit has impact on the external auditors work. This study attempts to assess the perceptions of external auditors towards the role of IAF on FRQ and transparency by adopting quantitative research approach in the Ethiopian context.

## MATERIALS AND METHODS

This study is descriptive research, aims to describe the opinions and attitudes of external auditors towards internal audits role on FRQ and transparency as it exists.

### Sampling methods

There were a total of 63 private audit firms in Ethiopia, registered in Federal Office of Auditor General (OFAG hereafter) as of 2013. This research was proposed to undertake on 12 purposive (judgment) sampled audit firms which located in Addis Ababa by distributing 140 questionnaires to employees. Contact persons were identified in the audit firms and potential respondents were then identified through the contact persons.

### Data Collection Instruments

Self administered questionnaire were distributed to respondents. 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 amenable to statistical analyses. Therefore, it was clearly stated in the instructions that the respondents expected to provide opinions on the statements based on their clients that maintain internal audit departments.

### 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 data collect via questionnaire were analyzed with descriptive statistics (mean and standard deviation) using statistical package for social scientists (SPSS version 16).

## RESULTS AND DISCUSSIONS

There were a total of 63 private audit firms and one state-owned audit firm in Ethiopia registered by the OFAG as of 2013. Based on the OFAG (2013) report, there were 4 A graded, 14 B graded, and 45 C graded private audit firms. Researchers targeted to collect data from A and B graded private audit firms that believed to have experienced auditors. However, it was distributed 140 questionnaires to auditors in 12 audit firms; 3 A graded and 9 B graded due to the difficulties of meeting the external auditors on their office. From the total of 140 questionnaires, 43 were collected (30.7% response rates) only. Although, the response rate is low, in similar area Paape *et al.* (2003) on the relationship between the IAF and Corporate Governance in the EU Survey had 22% response rate which was lower than the current study response

rate. Thus, the researchers interpreted the results based on the available data (or 30.7% response rate).

### General Information of Respondents

The information presented in table I, II and III shows that the general information of the external auditors participated under the study. The results indicated that most employees were degree holders (86.1%), but their experience and professional certification is low (more than 95% of respondents had less than ten years of experience and 65% respondents had not any professional certification). Consequently, it might affect the results due to their level of experience and certification (has effect on competency).

**Table I. Descriptive Statistics of educational level of Auditors**

		Frequency	Percent	Valid Percent
Valid	Diploma	1	2.3	2.8
	BA degree	31	72.1	86.1
	Masters	4	9.3	11.1
	Total	36	83.7	100.0
Missing	System	7	16.3	
	Total	43	100.0	

Source: Questionnaire Results, 2013

**Table II. Descriptive Statistics of years of experience as Auditors**

		Frequency	Percent	Valid Percent
Valid	One to Three	15	34.9	44.1
	Four to Seven	14	32.6	41.2
	Eight to Ten	4	9.3	11.8
	More than Ten	1	2.3	2.9
	Total	34	79.1	100.0
Missing	System	9	20.9	
	Total	43	100.0	

Source: Questionnaire Results, 2013

**Table III. Descriptive Statistics of professional certification of Auditors**

		Frequency	Percent	Valid Percent
Valid	Yes	11	25.6	25.6
	No	28	65.1	65.1
	On progress	4	9.3	9.3
	Total	43	100.0	100.0

Source: Questionnaire Results, 2013

### Internal Audit Function Practices

The results of the questions in table IV about internal audit practices distributed to external auditors, indicated a mean response of above 3.58 for all questions and above 1.00 standard deviations as per their most recent engagement, which would signify clients have an internal audit with the purpose and authority defined in line with the standard, and its purpose is communicated in the audit report. Moreover, the results imply that internal auditors receive full cooperation from clients and have full access to records, and companies consider internal audit as value adding service. The large standard deviations for all questions suggest that there is variation among perception of external auditors about internal audit practices.

### Internal Audit Function and Transparency

The result of the study as indicated in table V showed that from external auditor's perspective; IAF improve transparency and ensures management and accountability. However, there were differences among external auditors perception. This deviation might be due to IAF organizational setting, responsibility line and management support. External auditors also perceived that IAF analyze transparency level of organizational activities, add value and improve organization governance and it focus on risk and control. These indicated that IAF plays role in analyzing and improving transparency, and ensures accountability. According to Guxholli *et al.* (2012), internal auditors analyze the level of reporting transparency among parts of the governance structure. Furthermore, Julien and Rieger (2011) stated that internal audit understands concern for disclosure and transparency, aligning risk assessment with stakeholder expectations; addresses disclosure and transparency objectives; and understands the breadth and depth that is, the spectrum of disclosure and transparency possibilities and where the organization strives to be or should be on the spectrum. Hence, IAF plays a great role in organizations transparency. The results are consistent with current study.

### Internal Audit Function and Financial Reporting Quality

The results of the survey in table V indicated that mean response of 3.00 and 3.0476 to the questions "Internal audit is

**Table IV. Descriptive Statistics of IAF practices**

	N	Minimum	Maximum	Mean	Std. Deviation
IA has purpose and Authority	41	1.00	5.00	3.6098	1.09266
IA receive Cooperation of Auditees	43	1.00	5.00	3.6279	1.04707
IA has full Access to Records	43	1.00	5.00	3.5814	1.00552
IA is Value Adding service	41	2.00	5.00	3.9268	1.03417
Purpose of audit Communicated	42	1.00	5.00	3.9524	1.03482
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)

**Table V. Descriptive Statistics of IAF and Transparency**

	N	Minimum	Maximum	Mean	Std. Deviation
IA Improves Transparency	43	1.00	5.00	3.8837	1.13828
IA Analyzing Transparency Level	41	2.00	5.00	3.9756	.87999
IAF focus on risks and controls	42	1.00	5.00	4.2381	.84995
IAF ensures Mgt & Accountability	43	1.00	5.00	3.8140	1.02947
IA add value & improve Governance	43	2.00	5.00	4.1628	.84319
Valid N (listwise)	41				

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 V. Descriptive Statistics of IAF and Financial Reporting Quality

	N	Minimum	Maximum	Mean	Std. Deviation
Audit Report enhances Credibility FS	41	1.00	5.00	4.1463	1.01393
IAF crucial to stem Fraud and Abuse	43	1.00	5.00	3.6977	1.14507
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
Valid N (listwise)	41				

Note: FS – financial statement; QFI – quality financial information; 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

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 would signify that external auditors perceived that internal auditors independence is not clear. Thus, the IAF might not be effective because the independence of IAF is an important factor to ensure the effectiveness of audit work and to improve FRQ (Barac and Staden, 2009; Goodwin and Yeo, 2001; Mihret, 2010; Mihret and Yismaw, 2007). The perception of external auditors towards the IAF contribution to credibility of financial statement, stemming of fraud and abuse had mean response of 4.1463 and 3.6977 respectively. These revealed that IAF has a significant impact on FRQ in terms of detecting fraud and ensuring the integrity and reliability of financial statements. These results were consistent with the findings of (Coram *et al.*, 2008; Holt and DeZoortan, 2009) which showed that IAF has a significant impact on FRQ in terms of detecting and preventing fraud, and Tabără and Ungureanu (2012) stated that internal auditors are integral parts of corporate governance and their expertise in control has a primary contribution in ensuring the integrity and reliability of financial statements. However, the current study contradicts with findings of Shetwi *et al.* (2011) who worked on the impact of IAF on FRQ in Saudi listed companies revealed that IAF has no significant contribution to FRQ.

## Conclusion

The study revealed that according to external auditors view, IAF has a significant impact on FRQ in terms of detecting fraud and ensuring the integrity and reliability of financial information. IAF also analyze transparency level of organizational activities, add value and improve organization governance and it focus on risk and control. The researchers strongly suggest that it is better if internal audit report is included in annual report of companies like other reports (i.e. Chief Executive report, external auditor report, and management report) to enhance transparency and in turn to has effect on FRQ. Extensive future research needs in the internal audit area. Specifically, future researches required to conduct on internal audits and its effect on FRQ in different sectors.

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