EFFECT OF INTERNAL AUDIT ON THE EFFECTIVENESS OF CORPORATE GOVERNANCE IN MICROFINANCE BANKS

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ABSTRACT
This study examined the role of internal audit function on good corporate governance and investigate the contribution of internal audit function on microfinance banks financial performance in Ekiti State, Nigeria. The study used structured questionnaire to elicit information from the respondents (Chief Accountants and Internal Auditors) of the selected microfinance banks in Ekiti State. The ANOVA was used to test the significance level of the model, and the result shows that the relationship between internal audit and corporate governance practices is statistically significant. The result of the analysis using multiple regression techniques shows that the internal audit has a positive effect on the application of corporate governance in microfinance banks. The study concludes that the weak corporate governance structure contributed immensely to the recent crises experienced by microfinance banks in Nigeria. Thus, a quality internal audit function can affect the effectiveness and efficiency of the implementation of corporate governance.

Keywords: Internal audit, Corporate governance, Financial performance, Microfinance banks, Ekiti State

1. Introduction

Universally, business owners mainly establish company to increase its value through profits that have been set aside and also usually anticipate the possibility of irregularities such as the existence of nepotism, corruption and collusion, which could harm its growth. Eccentricities, therefore, that occur in an organization, could be prevented by the application of good corporate governance. Good corporate governance is argued to be essentially an antidote to overcome the various problems confronting organisations due to conflicts of interest from the parties involved (Zarkasyi, 2008; Bui *et al*., 2020).
Thus, corporate governance is generally regarded as the practice through which a company is managed and directed. It is arguably expediently growing in recognition, in the recent years, in response to financial reporting scandals such as Enron, WorldCom and Parmalat, which diminished confidence in the independence and reliability of not only the auditing firms involved, but also the accounting profession and financial markets as a whole (Ibrahim El-Sayed, 2011).

In Nigeria, over the years, the failure of some collapsed banks has connections with issues relating to ineffective application of corporate governance practices. This necessitated the amendment to the Central Bank of Nigeria (CBN) regulations the banking sector. Some regulatory bodies like the Nigerian Exchange Group also periodically update the established corporate governance for industries. This is with the intent to guide against corporate failure. For instance, the Code of Corporate Governance for the banking industry in Nigeria covers – board's responsibilities, their qualifications and composition, separation of powers, shareholders' rights, disclosure in the annual report, whistle blowing, risk management functions, compliance, disclosure and transparency, and internal audit, among others (CBN, 2019).

Similarly, the CBN in 2018 issued a Code of Corporate Governance for primary mortgage banks in Nigeria. The financial institutions are the microfinance banks, development finance banks, primary mortgage banks, mortgage refinance companies, finance companies and bureau de change. While the financial institutions are regulated to adhere to the provisions of the code of corporate governance, it is expected to be effectively achieved through the internal audit departments, headed by a Chief Compliance Officer/Head of Internal Audit (CBN, 2019). The internal audit is expected to identify and report on errors, problems and breaches of policy and procedure (Mbeba, 2007).

Despite this, there has been a concern among the regulators, scholars, financial experts and other stakeholders on the efficiency of the internal audit in view of the breaches of code of corporate governance among the microfinance banks. The breaches include the failure to timely conduct annual audit exercise, collapse of several licensed microfinance banks, and the rate of non-performing loans, among others. This position was corroborated with the revocation of the operating licenses of forty-two of these class of financial institutions by the CBN effective 12th November, 2020 (Nigerian Deposit Insurance Corporation, 2020). These include – King Solomon MFB, Credit Express MFB, Billionaire Blue Bricks MFB, Susu MFB, Aguda Titun MFB, and Hedgeworth MFB, etc. (Nigerian Deposit Insurance Corporation, 2020). The forty-two distressed microfinance banks (MFBs) are different from the previous two hundred and twenty-four whose licenses were recommended for revocation in September 2020. It is further argued that inadequate transparency accounted for the failure of the MFB (Romeu - CFI, 2020).

Consequent to this, scholars have opined that for good corporate governance to be effectively implemented, an efficient internal audit function is needed (Tunggal, 2009; Novatiani, 2017). To these scholars, the internal audit function would assist the management in carrying out their responsibilities and duties as demanded by the regulators. Thus, if the internal audit functions have been appropriately carried out, it is possible that some of the issues that led to the collapse of the distressed MFBs would have been detected early with appropriate solution provided.

Many studies, however, have asserted that internal audit has a very significant impact on the implementation of good corporate governance, such as the research conducted by Leung *et al.* (2002), Ruud (2003), Rezaee and Riley (2010) and Yassin *et al.* (2012) which state that internal audits in carrying out their roles to improve corporate governance must have skills, abilities and knowledge. Thus, the role of internal auditors is becoming increasingly important in terms of creating a good corporate governance structure (Nagy and Cenker, 2002; Carcell *et al.,* 2005; Allegrini *et al.,* 2006), but without any much studies on the MFbs in Ekiti State, Nigeria.

More so, a number of internal audits in microfinance banks in Nigeria are often not as independent as desired, due to lack of audit committees and lack of support from the senior management of the audited microfinance banks. Thus, some audit recommendations are not always implemented. Thus, this study aims to examine the effect of internal audit on the effectiveness of corporate governance in microfinance banks in Ekiti State, Nigeria.

2. Theoretical Review

2.1 Stakeholder's theory

Stakeholder theory argues that managers should make decisions so as to take account of the interests of all stakeholders in a firm including not only financial claimants, but also employees, customers, communities, governmental officials (Freeman, 1984). This is because a variety of services in the organization such as performance and operational audits will be able to guide the shareholders in monitoring the performance produced by the management and provide avenue for independent assessment on how effective the organization is performing (Kurniawan, 2012). Also, from a stakeholder perspective, an organization should attempt to meet multiple goals of a wide range of stakeholders rather than merely those of shareholders. Freeman (1984) argues that organizations should be more concerned about the interests of other stakeholders when taking strategic decisions.

The stakeholder theory relates to the term "accountability" which is defined by Peasnell *et al*. (1998) as the responsibility of one party to another in a relationship where one party entrusts another with the performance of certain duties. Hence it can be argued that financial reporting quality could reduce information asymmetry between the organization and its stakeholders in a timelier manner and as a consequence improve the relationships between them. Quality financial information can be provided to the various stakeholders in the circumstance that the firm has good corporate governance practices and a quality internal audit function. Stakeholder theory (Peasnell *et al*., 1998) requires managers to provide reliable information to the various stakeholders at all times. On the basis of stakeholder theory, firms with internal audit quality and board members who are independent of management, have expertise in financial related matters and can perform their roles are capable of meeting the various stakeholder needs.

2.2 Agency theory

In this study, we looked into agency theory which explains the relationship between the principal and the agent. The principal delegates the running of a business to the committee members who are the shareholders' agents (Clark, 2004). Also, Daily *et al.* (2003) argued that agency theory is ideal in explaining corporate governance studies because it is conceptually simple and reduces the corporation into two participants, that is to say managers and shareholders. The agency theory suggests that employees or managers in an organization can have self-interests and goals (Abdullah and Valentine, 2009), and these can be minimized by the auditors.

Auditors can check what management does in the absence of the shareholders. The shareholders monitor management activities through a well-constituted board of directors. The board of directors must also appoint the various committees, especially the audit committees, which according to Bananuka *et al*. (2018) can review corporate accounting information and liaise with external auditors. In the agency theory, the shareholders expect the agents to act or work and make decisions in the principal's interests, while on the contrary, the agents may not necessarily or willingly make decisions in the interests of the principals (Jensen and Meckling, 1976). Certainly, what should be noted is that the problem arising from the separation of ownership and control in agency theory has been confirmed by several scholars including Davis *et al*. (1997).

When the interests of the shareholders are not aligned to those of agents, the resources under the control of managers are not put to proper use, and in turn, accountability for such resources becomes questionable. Therefore, boards who represent the interests of shareholders are put in place to check what managers of MFIs do. These managers are expected to be competent enough to prepare financial statements in time with the appropriate disclosures that comply with accounting standards, and thus accountability is portrayed (Bakalikwira *et al*., 2017).

Positivist researchers have tended to focus on identifying circumstances in which the principal and agent are likely to have conflicting goals and then describe the governance mechanisms that limit the agent's self-serving behaviour (Eisenhardt, 1989). This stream has focused almost exclusively on the principal-agent relationship existing at the level of the firm between shareholders and managers. For example, Jensen and Meckling (1976), who fall under the positivist stream, propose agency theory to explain, inter alia, how a public corporation can exist given the assumption that managers are self-seeking individuals and a setting where those managers do not bear the full wealth effects of their actions and decisions.

The agency relationship explains the association between providers of corporate finances and those entrusted to manage the affairs of the firm. Jensen and Meckling (1976) define the agency relationship in terms of "*a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent*". Agency theory supports the delegation and the concentration of control in the board of directors and use of compensation incentives. The board of directors monitors agents through communication and reporting, review and audit and the implementation of codes and policies.

Eisenhardt (1989) explains that the agency problem arises when "*(a) the desires or goals of the principal and agent conflict and (b) it is difficult or expensive for the principal to verify what the agent is actually doing".* The problem is that the principal is unable to verify that the agent is behaving appropriately. Shleifer and Vishny (1997) explain the agency problem in the context of an entrepreneur, or a manager, who raises funds from investors either to put them to productive use or to cash out his holdings in the firm. They explain that while the financiers need the manager's specialized human capital to generate returns on their funds, the manager, since he does not have enough capital of his own to invest or to cash in his holdings, needs the financier's funds. But how can financiers be sure that, once they sink their funds, they get anything back from the manager? They further explained that the agency problem in this context refers to the difficulties financiers have in assuring that managers do not expropriate funds and or waste them on unattractive projects.

Drawing on the works of Jensen and Meckling (1976), Fama and Jensen (1983) seek to explain the survival of organizations characterized by the separation of ownership and control and to identify the factors that facilitate this survival. Their paper is concerned with the survival of organizations in which important decision agents do not bear a substantial share of the wealth effects of their decisions. In relation to the research objectives, this study will adopt the agency theory because, it focuses on the board of directors as a mechanism which dominates the corporate governance literature. The theory, further explain the association between providers of corporate finances and those entrusted to manage the affairs of the firm. This is also in accordance to the works of Sanda *et al*. (2005).

3. Methodology

This study adopted the survey research design and used the linear regression to investigate the relationship between internal audit and corporate governance effectiveness as well as the influence of internal audit on corporate governance effectiveness. The population of the study is made up of personnel (Chief Accountants and Internal Auditors) from microfinance banks in Ekiti State, Nigeria. The respondents were appropriately selected for the study given to their adequate knowledge and information on the internal auditing processes and governance of the MFBs. Primary data was used for this study through the administration of a structured questionnaire on selected respondents.

Through purposive sampling technique, a total number of one hundred and fifteen (115) questionnaire were distributed, while one hundred and four (104) were retrieved and found suitable for the analysis. The study also considered secondary data from annual reports of selected microfinance banks in Ekiti State, Nigeria. The ordinary least square regression analysis was used to ascertain if there is significant impact of internal audit on corporate governance mechanisms on microfinance bank's financial performance. Similarly, The ANOVA was used to test the significance and the fitness of the model considered in the study.

3.1 Model Specification

CGP = Corporate governance practices = Dependent variable
IA = Internal audit = Independent variable
Meanwhile,
CGP = f (SIAU, CIAS, EIC, IIAS, IIA,) …………………………………. (1)
CGP = β0 + β1SIAU + β2CIAS + βEIC + β4IIAS + β5IIA + μ ………… (2)
Where, SIAU = Size of the internal audit unit auditor's firm size
CIAS= Competence of internal audit staff
EIC = Auditor's independence
IIAS = Integrity of internal audit staff
IIA = Independent of internal audit
β0 = Constant
β1, β2, β3, β4 = Coefficient of the unknown variables
μ = Error term
A-priori expectation = β1, β2, β3, β4, β5, > 0

3.2 Data Presentation and Analysis

This research examined the relationship between internal audit and corporate governance practices of microfinance banks in Ekiti State, Nigeria. The 5-point Likert scale questionnaire was administered to enable the respondents to select between strongly agree (5), agree (4), neutral (3), disagree (2), and strongly disagree (1). In Table 1, the responses of the respondents to the questions raised in the questionnaire showed a high mean of at least 4.12 from a minimum mark of 2.00 and maximum mark of 5.00. In the 5-Likert scale method of questionnaire, the choices of the respondents, however, range from the least (strongly disagree -1) to the highest (strongly agree – 5). The data presented further implies that majority of the respondents believed that the components of internal audit (SIAU CIAS EIC IIAS IIA) influence changes in corporate governance practices in microfinance banks in Ekiti State. The data were analyzed using appropriate statistical tools and the results are clearly shown in Tables 1 – 4 (Appendices).

3.3 Discussions

Hypothesis Testing

Ho: There is no significant positive relationship between internal audit and corporate governance practices in microfinance banks in Ekiti State.
The regression analysis results in Table 2 shows R (0.820), R^2 (0.673), adjusted R^2 (0.652), and the standard error of estimate (0.26562). The value of R shows there is a strong relationship between the observed and the predicted values of the variables. This implies that internal audit affects corporate governance practices (82%). The value of R shows that the proportion of variation in the dependent variable is explained by the model. The value of R^2 indicates that 67.3% of the variation in the dependent variable could be explained by SIAU, CIAS, EIC, IIAS and IIA. The remaining 32.7% could be as a result of other variables not captured in this model. The adjusted R^2 value (65.2%), which is close to the

R^2 value (67.3%), indicates that the model is good for generalization.

The ANOVA in Table 3 tests the significance or otherwise, the fitness of the model. The F-calculated (40.340) is higher than the F-tabulated (0.000) at 5% significance level, hence, the null hypothesis is rejected. Table 4 also showed that the relationship between internal audit and corporate governance practices is statistically significant ($P = .02 < .05$) with t-statistics of 2.374. In consideration of these results, the study shows that internal audit (IA) has a significant positive influence on corporate governance practices of microfinance banks in Ekiti State (CGP). It also reveals that the t-calculated of 2.374 > t-tabulated of 0.020 at 5% level of significance. This shows that the null hypothesis should be rejected. This indicates that internal audit has a significant positive influence on corporate governance practices and this result is in agreement with the position of Odoh *et al*. (2018).

This is also affirmed from the results of the respective level of significance of the components of CGP, the individual level of significance for SIAU (0.172), CIAS (0.006), EIC (0.000), IIAS (0.646), and IIA (0.000) are lower than 5% acceptable level of significance. This means that when internal audit is applied to corporate governance practices, it will result in strengthening good corporate governance of microfinance banks. The output of the multiple regressions shown in the coefficient (Table 3) revealed that: CGP = 0.757 + 0. 53SIAU + 0.172CIAS + 0.200EIC + 0.028IIAS + 0.382IIA. Holistically, there is a strong indication that internal audit is significant for effectiveness of corporate governance in microfinance banks, which would improve bank's financial performance at the long-run. However, while the absence of effective internal audit weakens the desired effect of corporate governance on the growth of the banks, FMBs and regulatory agencies must regularly work hand-in-hand to formulate a more effective mechanism for adequate internal control and accountability of microfinance banks for a more efficient and sustainable corporate governance.

4. Conclusion and Recommendations

This study investigated the relationship between internal audit and corporate governance effectiveness in microfinance bank in Ekiti State. The results of the study revealed that there is a positive and strong linear relationship between internal audit and corporate governance of the microfinance banks in Ekiti State. The findings of the study further revealed that all the measures of internal audit have significant influence on corporate governance effectiveness. The study therefore, recommended the need for the regulatory agencies to device a more effective mechanism for adequate monitoring of the internal control department of micro finance banks for a more accountable, efficient and implementation of corporate governance.

Appendices

Table 1: **Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
SIAU	104	2	5	4.46	.696	-1.624	.237	3.658	.469
CIAS	104	4	5	4.46	.501	.157	.237	-2.015	.469
EIC	104	2	5	4.15	.665	-.990	.237	2.574	.469
IIAS	104	2	5	4.12	.754	-1.302	.237	2.546	.469
IIA	104	2	5	4.12	.754	-1.302	.237	2.546	.469
CGP	104	2	5	4.15	.822	-1.151	.237	1.375	.469
CGP	104	4	5	4.38	.489	.481	.237	-1.803	.469
CGP	104	2	5	4.35	.833	-1.549	.237	2.298	.469
CGP	104	2	5	4.15	.665	-.990	.237	2.574	.469
CGP	104	3	5	4.35	.553	-.062	.237	-.751	.469
Valid N (listwise)	104								

Table 2: **Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.820[a]	.673	.656	.26562	.673	40.340	5	98	.000	1.912

a. Predictors: (Constant), IIA, EIC, SIAU, CIAS, IIAS

b. Dependent Variable: CGP

Table 3: **ANOVA**

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	14.230	5	2.846	40.340	.000[a]
Residual	6.914	98	.071		
Total	21.145	103			

a. Predictors: (Constant), IIA, EIC, SIAU, CIAS, IIAS

b. Dependent Variable: CGP

Table 4: **Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B		Collinearity Statistics	
	B	Std. Error	Beta			Lower Bound	Upper Bound	Tolerance	VIF
1 (Constant)	.757	.319		2.374	.020	.124	1.390		
SIAU	.053	.038	.081	1.375	.172	-.023	.129	.956	1.046
CIAS	.172	.061	.191	2.818	.006	.051	.294	.729	1.372
EIC	.200	.040	.293	4.988	.000	.120	.279	.966	1.035
IIAS	.028	.045	.046	.621	.536	-.061	.116	.606	1.649
IIA	.382	.041	.636	9.227	.000	.300	.464	.703	1.422

a. Dependent Variable: TransCGP

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